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COMMENTS

THE LIQUIDATION-REINCORPORATION DEVICE — ANALYSIS AND PROPOSED SOLUTIONS

I. INTRODUCTION

Congress has determined that dividend distributions of a corporation will receive ordinary income treatment for tax purposes¹ while distributions in complete liquidation of a corporation will be taxed at capital gains rates.² This determination has provided the impetus for taxpayers to devise complex transactions designed to "bail-out" the earnings and profits³ of a corporation at capital gains rates while still continuing the business as a going concern.⁴ One device which has been successfully employed by taxpayers under the Internal Revenue Code of 1954 is what is known in common tax parlance as a liquidation-reincorporation.⁵ Basically, a corporation will liquidate and distribute cash and operating

1. INT. REV. CODE of 1954, § 301(c)(1). This subsection incorporates by reference section 316 which, when read in conjunction with section 301, provides that a distribution to a shareholder with respect to his stock shall constitute a dividend to the extent of the distributing corporation's accumulated or current earnings and profits. If a distribution exceeds these amounts, section 301(c)(2) calls for the excess to be offset against the basis of the shareholder's stock. If the basis is reduced to zero, section 301(c)(3) provides for the excess to be treated as a capital gain.

2. INT. REV. CODE of 1954, § 331(a)(1), provides that "[a]mounts distributed [to shareholders] in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock." With the liquidation characterized as an exchange, sections 1221 through 1223 then provides for the distribution to receive capital gains treatment.

3. "Earnings and profits" is a statutory term of art employed in section 316 of the Code to designate an amount of "surplus" in a corporation which, when distributed to shareholders with respect to their stock, will constitute a dividend subject to ordinary income treatment. It is somewhat anomalous that the Code does not define the term. Moreover, there does not seem to be a counterpart in state corporate law. B. BITTKER & J. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* § 5.03, at 152 (2d ed. 1966).

4. A preferred stock bail-out is another device which achieves this result. Although section 306 of the Internal Revenue Code of 1954 has, to a large extent, prevented this method of tax avoidance, it still has some vitality. See, e.g., Alexander Landis, *Bail-Outs and the Internal Revenue Code of 1954*, 65 YALE L.J. 909 (1956); Solomon, *How To Deal With Section 306*, U. So. CAL. 1968 TAX INST. 1967; Wolfberg, *Uses of Preferred Stock in Tax Planning for Closely Held Corporations*, 44 TAXES 52 (1966).

5. For general discussions of this problem, see Hewitt, *Liquidations v. Reincorporations and Reorganizations: The Current Battle*, 15TH ANNUAL TUL. TAX INST. 187 (1965); Kuhn, *Liquidation and Reincorporations Under the 1954 Code*, 51 GEO. L.J. 96 (1962); Lane, *The Reincorporation Game: Have the Ground Rules Really Changed?*, 77 HARV. L. REV. 1218 (1964); Margolin, *Corporate Liquidation and Subsequent Incorporation: Reorganization?*, 42 TAXES 464 (1964); Morrison, *The Line Between Liquidations and Reorganizations*, 41 TAXES 785 (1963); Nicholson, *Recent Developments in the Reincorporation Area*, 19 TAX L. REV. 123 (1964); Rice, *When is a Liquidation Not a Liquidation for Federal Income Tax Purposes?*, 8 STAN. L. REV. 208 (1956); Schwartz, *Reincorporations Under the 1954 Code*, 15. U. FLA. L. REV. 159 (1962); Whitaker, *Liquidation and Reincorporation*, U. So. CAL. 1966 TAX INST. 191.

assets to its shareholders who in turn will retain the cash and transfer the operating assets to a second corporation which they control. This transaction will result in the taxation of the earnings and profits of the liquidated corporation at capital gains rates rather than at ordinary income rates and will enable the business to continue under the same ownership and management. Though fully within the letter of the Code, such transactions represent a method of tax avoidance which clearly violates the intended operation of the Code sections employed to effectuate these transactions.⁶

This Comment will discuss the methods used to achieve a liquidation-reincorporation and the arguments which the Commissioner has urged under the 1954 and pre-1954 Internal Revenue Codes in seeking to disallow the benefits of these transactions. In addition, a format for the solution of this problem will be posited and compared with prior statutory proposals designed to eliminate the effectiveness of a liquidation-reincorporation.

II. HISTORY

Prior to the 1954 Code changes, liquidation-reincorporations did not constitute a serious problem. The Commissioner was able to "shoe-horn" a substantial number of these transactions into the very flexible language of the pre-1954 Code dealing with corporate reorganizations. Though these Code sections were not designed for the reincorporation transactions, the courts were able, through the use of judicially developed concepts, to implement the policy behind the reorganization section and thereby nullify any tax avoidance schemes.⁷

The principal weapon of the Commissioner at this point in time was the "D" type reorganization, defined as "a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its shareholders or both are in control of the corporation to which the assets are transferred."⁸ The word "control" in this definition was defined in section 112 (h) and required that the shareholders of the transferor corporation own at least "80 per centum of the total combined voting power of all classes of stock entitled to vote and at least 80 per centum of the total number of shares of all other classes of stock of the corporation."⁹

6. See p. 460 *infra* for a discussion of the policy underlying section 331 dealing with complete liquidations.

7. For an excellent discussion of the statutory and non-statutory corporate reorganization requirements under the pre-1954 Code, see Hewitt, *Liquidations v. Reincorporations*, 15TH ANNUAL TUL. TAX INST. 187, 189-215 (1965).

8. Int. Rev. Code of 1939, ch. 1, § 112(g)(1)(D), 53 Stat. 870 (now INT. REV. CODE of 1954, § 368(a)(1)(D)). The pre-1954 Code definition of a "D" reorganization did not change since its adoption in 1924.

9. Int. Rev. Code of 1939, ch. 1, § 112(h), 53 Stat. 40 (now INT. REV. CODE of 1954, § 368(c)). The requirement of control under the pre-1954 Revenue Act was

When the requirements of a "D" type reorganization could arguably be established, the consequences to the shareholders of the corporations involved would be two-fold. First, section 112 (b) (3)¹⁰ of the Code provided that no gain or loss would be recognized by the shareholders of the transferor if stock or securities of the transferor were exchanged, pursuant to a plan of reorganization,¹¹ for stock or securities in the transferee corporation.¹² Second, if other property was received in addition to stock or securities of the transferee corporation, a reorganization could still take place under section 112 (c) (1),¹³ but such other property could be recognized as income by the shareholders of the transferor if, in fact, gain was realized on the exchange. The gain, however, could not be recognized in excess of the sum of the cash and the fair market value of the other property received. If section 112 (c) (1) was applicable, section 112 (c) (2)¹⁴ provided that the gain recognized should be taxed as a dividend if the distribution had the effect of a dividend.¹⁵ Therefore, the effect of finding a "D" reorganization in a reincorporation transaction was that a distribution in liquidation of a corporation would not receive capital gains treatment,¹⁶ but would be taxed as a

10. Int. Rev. Code of 1939, ch. 1, § 112(b)(3), 53 Stat. 37 (now INT. REV. CODE of 1954, § 354(a)(1)).

11. The Commissioner viewed the requirement of a plan of reorganization literally. Treas. Reg. 103, § 29.112(g)-6(a) (1952), stated that the "plan of reorganization must be adopted by each of the corporations parties thereto; and the adoption must be shown by the acts of its duly constituted responsible officers, and appear upon the official records of the corporation." A split of authority developed, however, with respect to this requirement. The Sixth Circuit followed the view of the Service and required the adoption of a formal plan of reorganization. *United States v. Arcade Co.*, 203 F.2d 230, 233 (6th Cir.), *cert. denied*, 346 U.S. 828 (1953). Other circuit courts ignored the fact that there was no formal plan of reorganization when confronted with a reincorporation case. *Pebble Springs Distilling Co. v. Commissioner*, 231 F.2d 288 (7th Cir.), *cert. denied*, 352 U.S. 836 (1956), *aff'g* 23 T.C. 196 (1954); *Becher v. Commissioner*, 221 F.2d 252 (2d Cir. 1955), *aff'g* 22 T.C. 932 (1954); *Heller v. Commissioner*, 147 F.2d 376 (9th Cir. 1945), *aff'g* 2 T.C. 371 (1943). These courts generally reasoned that an informal plan of reorganization could be established on the facts of a reincorporation case and held this sufficient to satisfy the requirement.

For a discussion of the technical requirements of a "D" reorganization under the 1954 Revenue Act, see p. 440 *infra*.

12. See p. 428 *infra* for a more complete discussion.

13. Int. Rev. Code of 1939, ch. 1, § 112(c)(1), 53 Stat. 39 (now INT. REV. CODE of 1954, § 356(a)(1)).

14. Int. Rev. Code of 1939, ch. 1, § 112(c)(2), 53 Stat. 39 (now INT. REV. CODE of 1954, § 356(a)(2)). See p. 458 *infra* for an in-depth discussion of section 356(a)(1) and (2).

15. It was generally considered under the pre-1954 Code that "boot" distributions pursuant to a reorganization would receive automatic dividend treatment to the extent of the distributing corporation's earnings and profits. See *Commissioner v. Bedford's Estate*, 325 U.S. 283 (1945). However, cases decided under the 1954 Code question this result. See *Hawkinson v. Commissioner*, 235 F.2d 747 (2d Cir. 1956); *Idaho Power Co. v. United States*, 161 F. Supp. 807 (Ct. Cl. 1958); *William H. Bateman*, 40 T.C. 408 (1963). One authority believes that the language in section 356(a)(2) — "has the effect of a distribution of a dividend" — is not as static as most think. B. BITTKER & J. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* § 12.34, at 593 (2d ed. 1966), feel that this phrase permits each shareholder's "boot" distribution to be analyzed to determine if it should be given dividend treatment or redemption treatment pursuant to section 302(b) or section 346(a)(2).

16. Int. Rev. Code of 1939, ch. 1, § 115(c), 53 Stat. 46 (now INT. REV. CODE of 1954, § 331).

dividend under section 112 (c) (2) and receive ordinary income treatment.¹⁷ The obvious result would be that an attempted tax saving would result in an enormous tax burden.¹⁸

The cases prior to the adoption of the 1954 Code concerning liquidation-reincorporation can be placed for the purposes of analysis in three separate classifications according to the method employed to achieve the desired result. The first of these — pre-incorporation followed by a liquidation — presented the least problem for the Service. Generally, a typical situation would be that corporation A with substantial earnings and profits,¹⁹ would form a second corporation, corporation B, and transfer A's operating assets to B in exchange for the common stock of B. A, thus in possession of liquid assets and the stock of B, would then resolve to liquidate and distribute the stock and liquid assets to its shareholders.²⁰ B would then carry on the same business as A, with the same ownership and management, except in a different corporate form.

17. In addition to treating the "boot" distribution of the liquidating company as ordinary income, finding a reorganization under the pre-1954 Code had other consequences. First, section 112(b)(4), 53 Stat. 37 (now INT. REV. CODE OF 1954, § 361), provided that the transferor corporation recognized no gain on the exchange of its property for stock or securities in the transferee. Secondly, section 113(a)(7), 53 Stat. 41-42 (now INT. REV. CODE OF 1954, § 362), called for the tax basis of the transferor's assets to carryover to the transferee.

Under the present code, section 381 sets forth a comprehensive scheme for the carryover of corporate attributes, when a reorganization occurs. For a detailed discussion of this section, see B. BITTKER & J. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* §§ 13.10-43, at 615-708 (2d ed. 1966).

18. To illustrate this point under the 1954 code, assume that corporation A has a single shareholder who holds his stock at a basis of \$100,000. Corporation A then transfers its operating assets to corporation B in return for all of B's stock valued at \$100,000. A then resolves to liquidate and distributes B's stock on liquidation and cash of \$200,000 to its shareholder. Assuming the shareholder has no other income, if the distribution was found to be a valid liquidation pursuant to section 331(a), capital gains tax would be imposed on \$200,000 (\$200,000 earnings and profits plus \$100,000 of B corporation stock minus \$100,000 basis of A's stock). Section 1201(b) then imposes the following tax on the capital gains: one-half of the recognized gain (\$100,000) at ordinary rates plus 25 percent of the excess (\$100,000). The tax bill on this amount, employing section 1(a) of the Code, would be \$84,340.

However, if a reorganization was found, section 354 would allow corporation B's stock to be exchanged with out recognition of gain. The \$200,000 would be taxed pursuant to sections 356(a)(1) and (2). If this distribution is found to have the effect of a dividend and assuming that corporation A has sufficient earnings and profits, the amount of the tax at ordinary income rates would be \$135,840.

19. Another provision of the Code, Int. Rev. Code of 1939, ch. 1, § 102, 53 Stat. 35 (now INT. REV. CODE OF 1954, § 531) may have prompted taxpayers to effectuate a reincorporation. It provided for a tax to be levied on the net income of any corporation, if the corporation was "availed of for the purpose of preventing the imposition of the surtax upon its shareholders or the shareholders of any other corporation, through the medium of permitting earnings or profits to accumulate instead of being divided or distributed." The tax was 25 percent of the undistributed net income not in excess of \$100,000 and 35 percent of the net income in excess of \$100,000. Rather than have this tax imposed, a corporation would attempt a reincorporation with a view to having the earnings and profits taxed at capital gains rates.

20. *E.g.*, *Becher v. Commissioner*, 221 F.2d 252 (2d Cir. 1955), *aff'g* 22 T.C. 932 (1954); *Lewis v. Commissioner*, 176 F.2d 646 (1st Cir. 1949), *aff'g* 10 T.C. 1080 (1948); *Love v. Commissioner*, 113 F.2d 236 (3d Cir. 1940), *aff'g* 39 B.T.A. 172 (1939); *Ethel K. Lesser*, 26 T.C. 306 (1956); *Austin Transit, Inc.*, 20 T.C. 849 (1953); *Estate of Elise W. Hill*, 10 T.C. 1090 (1948); *Morley Cypress Trust*, Schedule "B", 3 T.C. 84 (1944); *Hortense A. Menefee*, 46 B.T.A. 865 (1942).

The Service found little difficulty in finding that this type of transaction came within the literal language of the "D" reorganization.²¹ There was in these cases a transfer of assets by a corporation to another corporation and the transferor was in control of the transferee immediately after the transfer. Although in most cases no formal plan of reorganization existed, the courts were able to find informal plans which they held sufficient to afford the transaction reorganization treatment.²² The only factor which did not fit the reorganization scheme was the liquidation of the transferor. Arguably it was a transaction separate from the reorganization which entitled it to be taxed as a capital gain rather than as ordinary income. However, the courts found the liquidation incident to the reorganization since the entire plan would be fruitless without the transferor's liquidation.²³

The second type of transaction — sale of assets followed by a liquidation — proved more difficult to justify under the literal requirements of a "D" reorganization. However, through application of the "step transaction" concept,²⁴ the Commissioner was successful in employing the "D" definition to thwart an earnings bail-out. Basically, the shareholders of one corporation, corporation A, would form a second corporation, corporation B, with a minimum of capital. B would then purchase the operating assets of A for cash and continue the same business. Corporation A would then completely liquidate and distribute its earnings and profits at capital gains rates.²⁵ This device was more attractive than the pre-incorporation-liquidation scheme previously discussed. In addition to bailing out the earnings at capital gains rates, a new basis would

21. In *Lewis v. Commissioner*, 176 F.2d 646 (1st Cir. 1949), the court stated that Congress intended the reorganization sections to cover a reincorporation since "the essence of a statutory reorganization is a continuance of the proprietary interests in the continuing enterprise under modified corporate form, the transaction being deemed insufficiently closed economically to justify a tax at the time, except in so far as the stockholder gets something in addition to stock or securities in the reorganized company." *Id.* at 648, quoting Darrell, *The Scope of the Commissioner v. Bedford Estate*, 24 TAXES 266, 272 (1946). In *Estate of Elise W. Hill*, 10 T.C. 1090 (1948), the Tax Court found that a reincorporation fell within the "letter" and "spirit" of the "D" reorganization even though only 44 percent of the assets of the disappearing corporation were transferred to a continuing enterprise in exchange for its stock or securities. *Id.* at 1094.

22. *Hortense A. Menefee*, 46 B.T.A. 865, 868 (1942). See also note 11 *supra*. For a discussion of this requirement under the 1954 Code, see p. 440 *infra*.

The reasoning which the courts employed to reach this conclusion is best exemplified by a quote from William M. Liddon, 22 T.C. 1220 (1954):

Even though there was no formal written plan, the various transactions — the sale of Davis's stock, the formation of a new corporation, the transfer of assets from the old to the new corporation, the liquidation of the old corporation after the new corporation was in business — all indicate a master plan of reorganization rather than the mere liquidation of the old corporation.

Id. at 1225.

23. *Becher v. Commissioner*, 221 F.2d 252, 254 (2d Cir. 1955), *aff'g* 22 T.C. 932 (1954); *Lewis v. Commissioner*, 176 F.2d 646, 649 (1st Cir. 1949), *aff'g* 10 T.C. 1080 (1948); *Estate of Elise W. Hill*, 10 T.C. 1090, 1096 (1948); *Morley Cypress Trust*, Schedule "B", 3 T.C. 84, 86 (1944).

24. For a complete discussion of the "step-transaction" doctrine, see p. 443 *infra*.

25. *E.g.*, *Pebble Springs Distilling Co. v. Commissioner*, 231 F.2d 288 (7th Cir.), *cert. denied*, 352 U.S. 836 (1956), *aff'g* 23 T.C. 196 (1954); *Liddon v. Commissioner*, 230 F.2d 304 (1st Cir. 1956), *aff'g* 23 T.C. 1220 (1954). See also *other grounds*,

be attributed to the property, in the amount of its actual cost to the transferee.²⁶ Under the first method the assets were exchanged for stock and the basis in the hands of the transferee would be the same as the basis in the hands of the transferor.²⁷ Therefore, if the market value of the property was in excess of the transferor's basis the assets would be placed on the transferee's books at a stepped-up rate, thereby enabling the same business, in a different corporate form to "re-depreciate" the same assets.²⁸

In this second situation there was some difficulty in establishing a "D" reorganization and the consequent dividend treatment²⁹ of the liquidation resulted from the fact that there was no stock for stock exchange as required by section 112 (b) (3). To the contrary, the stock of the transferee was purchased for cash by the stockholders.³⁰ This barrier to the finding of a reorganization was overcome by the courts when they analyzed these cases under the step-transaction doctrine.³¹ The substance of this doctrine is that transactions leading to one result cannot be viewed separately and independently for tax purposes but must be considered together in order to arrive at the true nature of a particular transaction.³² By telescoping the transactions the courts found that the

22 T.C. 1220 (1954); *Heller v. Commissioner*, 147 F.2d 376 (9th Cir.), *cert. denied*, 325 U.S. 868 (1945), *aff'g* 2 T.C. 371 (1943).

It should be noted that there was no counterpart in the 1939 Code to section 337 of the 1954 Internal Revenue Code, which provides that the gain from the sale of assets by a corporation is not recognized if the corporation adopts a plan of liquidation and completely liquidates within a 1-year period. Therefore, any gain realized on the sale of assets would necessarily increase the amount of earnings and profits and thereby increase the amount of the liquidating distribution which could be tagged as a dividend if the sale of assets-liquidation was found to be a reorganization. In order to evade this adverse effect of a sale of assets-liquidation, a corporation would sell its assets at book value. *E.g.*, *Liddon v. Commissioner*, 230 F.2d 304, 306 (6th Cir. 1956).

For an example of how earnings and profits are computed, see B. BITTKER & L. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* § 503, at 152 (2d ed. 1966).

26. Int. Rev. Code of 1939, ch. 1, § 113(a), 53 Stat. 40 (now INT. REV. CODE of 1954, § 1012).

27. Int. Rev. Code of 1939, ch. 1, § 113(a)(6), 53 Stat. 41 (now INT. REV. CODE of 1954, § 362).

28. Although the assets will still be carried on the transferee's books at cost, the "recapture provisions" of the 1954 Code, sections 1245 and 1250, introduced in 1962, may minimize the tax advantages of this type of reincorporation.

29. For the purposes of discussion we are assuming that the "boot" portion of the liquidating distribution has the effect of a dividend. As noted earlier, this may not always be the case. *See* note 15 *supra*.

30. Generally, the shareholders of the disappearing corporation would obtain a bank loan which they would use to purchase the stock in the continuing business. With this capital the entity would purchase the operating assets of the disappearing corporation. When the liquidated company made its final distribution at least part of the cash would be made up of these borrowed funds. For an example of the complexity of these transactions, see *Heller v. Commissioner*, 147 F.2d 376, 377-78 (9th Cir. 1945).

31. *See* p. 443 *infra* for a complete discussion of this concept.

32. *Liddon v. Commissioner*, 230 F.2d 304, 309 (6th Cir. 1956); *Heller v. Commissioner*, 147 F.2d 376, 378 (9th Cir. 1945).

In *Helvering v. Alabama Asphaltic Limestone Co.*, 315 U.S. 179 (1942), the Supreme Court sanctioned the use of the step-transaction doctrine when it stated that "[t]ransitory phases of an arrangement frequently are disregarded under these [reorganization] sections of the revenue acts where they add nothing of substance to the completed affair." *Id.* at 184-85.

literal definition of a "D" reorganization was met since what took place was a transfer of assets by a corporation, albeit by sale, to another corporation which was controlled by the transferor's shareholders immediately after the transfer. The payment of cash for the transferee's stock was immaterial to finding a reorganization because the same amount of cash was eventually returned to the shareholders upon liquidation of the transferor.³³ Although some courts merely ignored the fact that there was no stock for stock exchange,³⁴ others reasoned that since the shareholders of the disappearing corporation were in control of the new corporation the net effect was that an exchange took place.³⁵ This method of analysis may be justified by the fact that section 112 (b) (3) did not define a "D" reorganization, but rather prescribed the consequences of a stock for stock exchange when it occurred pursuant to any type of reorganization. It may be concluded, therefore, that such an exchange was not a prerequisite to the finding of a "D" reorganization under the pre-1954 Code.³⁶

The final device, a liquidation followed by a reincorporation, was probably the least complex, yet proved to be the nemesis of the Commissioner under the pre-1954 Code. Corporation A would liquidate and distribute its operating assets in kind (usually held in trust) and its liquid assets to its shareholders. The former stockholders of corporation A would then form corporation B and transfer the former operating assets of A to B³⁷ in exchange for B's stock, retaining for themselves

33. See note 30 *supra*. The Court of Appeals for the Sixth Circuit in *Liddon v. Commissioner*, 230 F.2d 304 (6th Cir. 1956), found, however, that to the extent of any personal contribution to the capital of the new company by the taxpayer, the liquidating distribution of the disappearing corporation could not have the effect of a dividend since "its effect was the repayment of an advance." *Id.* at 309.

34. *E.g.*, *Walter S. Heller*, 2 T.C. 371 (1943).

35. *Liddon v. Commissioner*, 230 F.2d 304, 307 (6th Cir. 1956).

36. This is supported by the Third Circuit's opinion in *Commissioner v. Morgan*, 288 F.2d 676 (3d Cir. 1961), *rev'g* 33 T.C. 30 (1959). There, a mutual fund had separate contracts with the transferor company for investment advisory services and with the transferee for the promotion of the fund's securities. The latter two corporations were commonly controlled by the taxpayer and, in 1952, for the purpose of improving their efficiency, the transferee brought both service organizations under one corporate veil. The contract of the transferor company was terminated and the mutual fund contracted immediately thereafter for the same services from the transferee. In addition, equipment and employees of the transferor were passed to the transferee. The transferor was then liquidated and the Commissioner alleged that these transactions constituted a "D" reorganization denominating the liquidating distribution as a dividend to the extent of earnings and profits. The Court of Appeals for the Third Circuit reversed the Tax Court and found a "D" reorganization absent a stock for stock exchange reasoning that the issuance of new stock would have been a "meaningless gesture" since the taxpayer already controlled both companies.

Under the 1954 Code a stock for stock exchange is seemingly necessary before a reorganization is found since section 368(a)(1)(D) incorporates by reference section 354 which requires such an exchange. For a discussion of this requirement under the 1954 Code, see p. 440 *infra*.

37. Int. Rev. Code of 1939, ch. 1, § 112(b)(5), 53 Stat. 37 (now INT. REV. CODE of 1954, § 351), provided that "[n]o gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation, and immediately after the exchange such person or persons are in control of the corporation."

the liquid assets of A.³⁸ Difficulty in finding a "D" reorganization arose because the assets were transferred by the former stockholders and not by the corporation, as the definition of a "D" reorganization required.³⁹ At least two circuits⁴⁰ required strict compliance with the definitional requirements of a "D" reorganization and reasoned that once the old corporation liquidated, the shareholders were under no legal obligation to transfer the assets to a second corporation. Without some legal duty on the former shareholders the Sixth Circuit felt that the liquidation of A and subsequent transfer to B should be afforded separate tax treatment and could not be telescoped to arrive at a reorganization.⁴¹ Other circuits, confronted with the same factual situation, gave greater weight to the spirit of the reorganization sections rather than their literal language and employed the step-transaction doctrine to find a "D" reorganization, based on the reasoning that the former shareholders acted as a mere conduit through which the operating assets passed from the transferor to the newly formed transferee corporation.⁴²

Prior to the 1954 Code, therefore, the Commissioner could generally utilize the definition of a "D" reorganization as an effective way to thwart these tax avoidance schemes. However, the problem with analyzing these transactions under that definition, or any of the reorganization definitions, lies in the fact that they were not intended for this purpose. According to one commentator the purpose of the reorganization sections

was to facilitate changes in corporate structure, dictated by business needs but not involving substantial economic transfers to third parties or withdrawals from corporate solution, so as to prevent the fossilization of business forms which would occur if all corporate adjustments of such a nature were subject to tax.⁴³

They were drafted then for the benefit of the taxpayers and not for the Commissioner. Although it has been seen that the Tax Court and the circuit courts of appeal were, for the most part, successful in expanding the meaning of the "D" type reorganization without doing violence to it, this was not always possible. For example, in *Austin Transit, Inc.*⁴⁴ the owners of one company liquidated and transferred all the assets to

38. *E.g.*, *Bard-Parker Co. v. Commissioner*, 218 F.2d 52 (2d Cir. 1954), *cert. denied*, 349 U.S. 906 (1955); *United States v. Arcade Co.*, 203 F.2d 230 (6th Cir.), *cert. denied*, 346 U.S. 828 (1953); *Survaunt v. Commissioner*, 162 F.2d 753 (8th Cir. 1947), *aff'g* 5 T.C. 665 (1945); *Hendricksen v. Braicks*, 137 F.2d 632 (9th Cir. 1943).

39. *See* p. 424 *supra* for the definition of a "D" reorganization.

40. *United States v. Arcade Co.*, 203 F.2d 230 (6th Cir.), *cert. denied*, 346 U.S. 828 (1953); *Hendricksen v. Braicks*, 137 F.2d 632 (9th Cir. 1943).

41. *United States v. Arcade Co.*, 203 F.2d 230, 233 (6th Cir.), *cert. denied*, 346 U.S. 828 (1953); *Hendrickson v. Braicks*, 137 F.2d 632, 635 (9th Cir. 1943).

42. *Bard-Parker Co. v. Commissioner*, 218 F.2d 52, 56 (2d Cir. 1954), *cert. denied*, 349 U.S. 906 (1955); *Survaunt v. Commissioner*, 162 F.2d 753, 755 (8th Cir. 1947).

43. Hewitt, *Liquidations v. Reincorporations and Reorganizations: The Current Battle*, 15TH ANNUAL TUL. TAX INST. 187, 193 (1965).

44. 20 T.C. 849 (1953).

three new companies. However, the prior owners of the liquidated corporation only owned 70 percent of the stock of the new companies. The Tax Court held that the 80 percent control test of section 112 (h) was an essential requirement without which a reorganization could not take place.⁴⁵ Taxpayers, therefore, could effectuate a liquidation-reincorporation without the threat of having the transaction being "shoe-horned" into a "D" reorganization if they were willing to relinquish 21 percent or more of the common stock of the transferee company.

III. THE 1954 CODE

A. History

The House version of the 1954 Code initially contained a section specifically directed at the liquidation-reincorporation transaction.⁴⁶ The section was, however, deleted and the Joint Committee report gave the following explanation for the deletion:

The possibility of tax avoidance in this area is not sufficiently serious to require special statutory provision. It is believed that this possibility can appropriately be disposed of by judicial decision or by regulation *within the framework of the other provisions of the bills*.⁴⁷

The Commissioner accepted the invitation of the Joint Committee and thereafter promulgated Treas. Reg. § 1.301-1 (1)⁴⁸ and Treas. Reg. § 1.331-1 (c)⁴⁹ in an effort to prevent what was viewed as an earnings bail-out.⁵⁰ Treas. Reg. § 1.331-1 (c) provides that a liquidation which is either preceded or followed by a reincorporation "of all or part of the assets of the liquidating corporation may, however, have the effect of the distribution of a dividend or of a transaction in which no loss is recognized and gain is recognized only to the extent of 'other property.' See sections 301 and 356."⁵¹ This language appears to indicate that if the reincorporation transaction is not found to be a reorganization under section 368,⁵² thereby bringing into operation section 356,⁵³ then the distributions upon liquidation may have the effect of a dividend under section 301.⁵⁴ In effect, the regulation ignores the fact

45. *Id.* at 856.

46. For a discussion of this Code section, see pp. 452-56 *infra*.

47. H.R. REP. NO. 2543, 83d Cong., 2d Sess. 41 (1954) (emphasis added).

48. Treas. Reg. § 1.301-1(1) (1955).

49. Treas. Reg. § 1.331-1(c) (1955).

50. See pp. 426-31 *supra* explaining how an earnings bail-out is accomplished.

51. Treas. Reg. § 1.331-1(c) (1955).

52. INT. REV. CODE OF 1954, § 368. Section 368 defines a reorganization for the purposes of the non-recognition treatment accorded such a transaction under INT. REV. CODE OF 1954, § 354.

53. INT. REV. CODE OF 1954, § 356. For a more complete discussion of the mechanics of applying section 356, see pp. 457-58 *infra*.

54. INT. REV. CODE OF 1954, § 301. A distribution falling within section 301 will be given ordinary income treatment to the extent of the distributing corporation's

of liquidation and treats the distribution as a redemption of stock notwithstanding its failure to refer to section 302.⁵⁵ However, once Treas. Reg. § 1.301-1 (1) is examined it is apparent that the references to sections 301 and 356 in Treas. Reg. § 1.331-1 (c) are not to be read as mutually exclusive of each other. Treas. Reg. § 1.301-1 (1) provides that:

A distribution to shareholders with respect to their stock is within the terms of section 301 although it takes place at the same time as another transaction if the distribution is in substance a separate transaction whether or not connected in a formal sense. This is most likely to occur in the case of a *recapitalization*, a *reincorporation* or a *merger of a corporation with a newly organized corporation having substantially no property*.⁵⁶

This language clearly indicated that the Commissioner was ready to take the position that distributions to shareholders in a reincorporation transaction would be treated as a dividend under section 301 notwithstanding the fact that it might be a "D" type, "E" type or "F" type⁵⁷ reorganization and that section 356 would not control the extent and character of the shareholder's gain upon liquidation. It may appear at this juncture that whether or not the reincorporation transaction was a reorganization would be immaterial since any distributions in such a transaction would be treated as a section 301 dividend. However, it would still be necessary for the Service to take the position that a reincorporation transaction was a reorganization in order to bring into operation sections 362⁵⁸ and 381⁵⁹ providing for the carryover of basis for capital assets and other tax attributes of the disappearing corporation. This, in itself, places the Service in an anomalous position in that when it argues that the liquidation transaction is a reorganization it thereby brings into operation section 356 which specifically provides for the treatment of "boot" in a reorganization transaction. The Service must then either ignore or argue against the application of section 356 — which is directly tied to the reorganization provisions⁶⁰ — in favor of section 301 treatment for the property, other than section 354 property, which is received by the shareholders on liquidation. The inconsistency of this position

earnings and profits. *But see* pp. 447-48 *infra*: J.E. Davant v. Commissioner, 366 F.2d 874 (5th Cir. 1966), *aff'g in part and rev'g in part* South Texas Rice Warehouse Co., 43 T.C. 540 (1965), *cert. denied*, 386 U.S. 1022 (1966).

55. INT. REV. CODE of 1954, § 302. Subsection (b) provides that where a redemption of stock has the effect of a dividend it will be treated as such under section 301.

56. Treas. Reg. § 1.301-1(1) (1955) (emphasis added).

57. INT. REV. CODE of 1954, §§ 368(a) (1) (D), (E), (F). In Joseph C. Gallagher, 39 T.C. 144 (1962), *acquiesced in result only*, 1964-2 CUM. BULL. 5, the Commissioner clearly advocated this approach. *See also* J.E. Davant v. Commissioner, 366 F.2d 879 (5th Cir. 1966), *aff'g in part and rev'g in part* South Texas Rice Warehouse Co., 43 T.C. 540 (1965), *cert. denied*, 386 U.S. 1022 (1967).

58. INT. REV. CODE of 1954, § 362.

59. INT. REV. CODE of 1954, § 381.

60. *See* pp. 434-35 *infra*.

has been criticized by numerous authors⁶¹ and has found little or no support in the cases decided under the 1954 code.⁶²

The Service, however, has persisted in its stand as evidenced by Rev. Rul. 61-156.⁶³ The situation presented by that revenue ruling is that of a corporation, which, upon adoption of a plan of complete liquidation under section 337,⁶⁴ sold substantially all of its assets to another corporation which was recently formed by the management of the selling corporation in exchange for stock, long term notes, and cash. The new, purchasing, corporation immediately thereafter sold 55 percent of its stock to the public, thereby diluting the interest of all of the old corporation's shareholders receiving stock in the new corporation to 45 percent. The question presented was whether the distribution in liquidation of the former corporation was pursuant to a plan of reorganization under section 368 or was to be treated in accordance with the provisions of sections 331⁶⁵ and 337 pertaining to corporate liquidations. The Service ruled that a reorganization had occurred within the meaning of sections 368 (a) (1) (E) or (F) notwithstanding the fact that 55 percent of the stock of the purchasing corporation was owned by persons other than those who held shares in the liquidating corporation. Furthermore, it was held that the cash and notes distributed as part of the liquidation constituted a dividend within the purview of section 301. With respect to the application of section 301 to the "boot" received, the Commissioner felt that it was not part of the consideration for the stock transferred pursuant to the reorganization but was a separate distribution having the effect of a dividend under section 301.

From this ruling it appears that the Service will take the position that the typical reincorporation transaction must be segregated into separate and distinct transactions. Those parts of the total transaction which are to be split off as separate and distinct would be those creating a proprietary interest in others and the distribution of liquid assets to the shareholders of the disappearing corporation. Whether the receipt

61. *E.g.*, Hewitt, *Liquidations v. Reincorporations and Reorganizations: The Current Battle*, 15TH ANNUAL TUL. TAX INST. 187, 231-35 (1965); Lipkind, *Gallagher Revisited: The Functionally Unrelated Corporate Reorganization*, 13 VILL. L. REV. 487, 517-20 (1968); Rice, *When is A Liquidation Not a Liquidation For Federal Income Tax Purposes*, 8 STAN. L. REV. 208, 225-28 (1956).

62. *See, e.g.*, Joseph C. Gallagher, 39 T.C. 144 (1962), *acquiesced in result only*, 1964-2 CUM. BULL. 5.

63. 1961-2 CUM. BULL. 62. This ruling revoked the Service's prior "Baseball ruling," Rev. Rul. 56-541, 1956-2 CUM. BULL. 189, which stated that where 80 percent of the stockholders of the old corporation owned 45 percent of the stock of the new corporation, there was no reorganization and that the distribution in liquidation was not subject to dividend treatment.

64. INT. REV. CODE OF 1954, § 337. Generally, section 337 provides for the non-recognition of gain or loss at the corporate level when a corporation adopts a plan of complete liquidation to be carried out within one year.

65. INT. REV. CODE OF 1954, § 331. Section 331 provides that distributions in complete liquidations shall not be taxed in accordance with the rules of section 301. As to partial liquidations, see INT. REV. CODE OF 1954, § 346.

of the boot and changes in proprietary interests can be separated from the reorganization transaction has not gone unquestioned.⁶⁶

One criticism of this position can be made on the basis that when the Joint Conference Committee made reference to "other provisions of the bill" it had in mind the sections of the 1939 Code dealing with the reincorporation transactions and the manner in which they were applied by the courts.⁶⁷ The general weapon used, as noted previously, was the finding of a reorganization under section 112 (g) (1) (D) and the treatment of boot under section 112 (c) (1) and (2) of the 1939 Code. It should be noted that in the revenue ruling no mention of subsection (D) of section 368 (a) (1) is made.⁶⁸ Instead, the Commissioner found that either an "E" or "F" type reorganization had occurred. From this, an argument could be made against the position of the Service in the revenue ruling on the basis that sections 368 (a) (1) (E) and (F) and section 301 were not intended by Congress to meet the reincorporation problem, but rather the transaction was to be subjected to "D" type reorganization treatment as was done under the 1939 Code. However, considerable doubt existed as to whether the Commissioner could achieve the same results under the 1954 Code in light of the various changes in the wording of what constituted a "D" type reorganization.

B. "D" Type Reorganization

As now defined in section 368 (a) (1), a "D" type reorganization requires that: (1) the disappearing corporation transfer all or a part of its assets to another corporation; (2) the surviving corporation be controlled by the transferor or one or more of its shareholders; (3) stock or securities of the transferor corporation are distributed pursuant to a plan of reorganization; and (4) the transaction qualifies under section 354, 355, or 356. The major changes in the definition of a "D" type reorganization arise from adding the requirements that stock or securities of the transferor corporation be distributed pursuant to a plan and the references made to sections 354, 355, and 356.

The most important aspect of the changes made are the references to sections 354, 355, and 356. These referrals were apparently necessary in order to include the section 355 "divisive reorganization" within the definition of a "D" type reorganization. However, section 355⁶⁹ does not apply in that in the reincorporation transaction one business rather than two flows from the reorganization as contemplated by section 355.

66. See pp. 443-44 *infra*. Compare *Reef Corp. v. Commissioner*, 368 F.2d 125 (5th Cir. 1966), *rev'g in part*, 24 CCH Tax Ct. Mem. 379 (1965), *cert. denied*, 386 U.S. 1018 (1966) with Joseph C. Gallagher, 39 T.C. 144 (1962), *acquiesced in result only*, 1964-2 CUM. BULL. 5.

67. See pp. 424-31 *supra*.

68. This is probably because of the numerous statutory requirements of finding a "D" reorganization. See pp. 436-43 *infra*.

69. INT. REV. CODE of 1954, § 355.

Therefore, for the purposes of determining whether a reincorporation transaction qualifies as a "D" type reorganization it becomes necessary to determine if the transaction qualifies under either section 354 or 356 or both.

Upon examination of section 356 it is clear that it will only serve to qualify a transaction which would otherwise qualify under section 354 or 355 but for the receipt of "boot" as part of the reorganization. Therefore, it is clear that qualifying under section 354 becomes one of the most crucial steps in the road to finding a "D" reorganization.

Generally, section 354 provides for the non-recognition of a gain or loss in a transaction where "stock or securities in a corporation a party to a reorganization are . . . exchanged solely for stock or securities . . . in another corporation a party to the reorganization."⁷⁰ However, subsection (b) qualifies this general non-recognition provision by providing that non-recognition shall not apply to a "D" type reorganization unless: "(A) the corporation to which the assets are transferred acquires *substantially all* of the assets of the transferor of such assets . . ."⁷¹ From this language it becomes clear that in order to have a "D" type reorganization which qualifies under section 354, "substantially all" the assets of the transferor corporation must be transferred to the transferee corporation notwithstanding the language in section 368 (a) (1) (D) referring to the transfer of "all or *part*" of the transferor's assets.⁷² This particular requirement of a "D" reorganization has caused the greatest amount of controversy as to how it would affect pre-1954 Code decisions dealing with the reincorporation transaction. As will be seen, this change in language along with the other change previously mentioned, has not, to any great degree, changed results which might have been obtained by applying the provisions governing the "D" reorganization in the 1939 Code.⁷³ What has developed to be more of a problem is the characterization of the reincorporation transaction as an "F" type reorganization rather than the "D" type. However, at this juncture the examination of the reincorporation transaction under subsection (D) will continue and consideration of subsection (F) will be deferred to a later point.⁷⁴

70. INT. REV. CODE of 1954, § 354(a).

71. INT. REV. CODE of 1954, § 354(b) (1) (A) (emphasis added).

72. This difference in wording probably arises from the fact that section 355 divisive reorganizations are also covered by section 368(a)(1)(D). Thus the "D" definition had to be worded broadly enough to cover the divisive type and section 354 reorganization.

73. See pp. 426-31 *supra*.

74. See pp. 446-52 *infra*.

1. *The Requirement of "Substantially All"*

The decision of the Tax Court in *John G. Moffatt*⁷⁵ was the first time that a court dealt directly with the issue of the meaning of "substantially all" the assets as used in section 354(b)(1)(A). The position which the court took on this issue is probably best expressed by a quote which in part came from the *Southland Ice Co.*⁷⁶ case. The court in *Moffatt* stated: "And finally, it must be remembered that the 'substantially all' requirement has been subjected to [a] construction which *in effect* applies a *continuity test* rather than mere blind percentages."⁷⁷ The test of continuity referred to by the court is one which requires that "[i]n one form or another the new company has the use and benefit of all the assets relating to the operation of the business, [by the successor corporation] whether by 'loans,' 'rentals' of equipment followed ultimately by sale thereof, or otherwise."⁷⁸

In the *Moffatt* case, the Tax Court was faced with the liquidation of an engineering consulting firm where land was distributed to the shareholders but was not either leased, sold, or otherwise transferred to the new corporation. The cost of this land represented a significant portion of the assets found in the balance sheet of the liquidating corporation. However, because the land was not necessary to the continued operation of the consulting business its transfer was not considered in determining whether the liquidating corporation transferred "substantially all" its assets. The Tax Court found that the staff of skilled employees was more significant in relation to the operation of a consulting business and found that by virtue of the transfer of all the employees to the payroll of the new corporation and the transfer of cash and other furniture and fixtures to the new corporation, that "substantially all" of the operating assets, within the purview of section 354(b)(1)(A), had been transferred to the new corporation.

At this point it would seem clear that the Tax Court would not rely solely on the schedule of balance sheet assets and liabilities to determine whether "substantially all" the assets⁷⁹ have been transferred. The operations of the surviving corporation will be scrutinized to determine the degree of continuity in the operation of its business with that of the business of the predecessor. Thus, such items as the loss of good will due to a change in name, or losses of key personnel, as well as the transfer of outstanding contracts or work on such contracts, and any

75. 42 T.C. 558 (1964), *aff'd*, 363 F.2d 262 (9th Cir. 1966), *cert. denied*, 386 U.S. 1016 (1967). See also *Retail Properties, Inc.*, 23 CCH Tax Ct. Mem. 1463 (1964); *Ralph C. Wilson, Sr.*, 46 T.C. 334 (1966).

76. 5 T.C. 842 (1945).

77. 42 T.C. at 578.

78. *Id.* at 579.

79. *But see* *J. Jay Rommer*, 268 F. Supp. 740 (D.N.J. 1966), where the court said that percentages of assets transferred may be relevant. It may appear that the court will look to the percentage transferred in relation to "operating assets." However, the test is more one of continuity than "blind percentages," although such a percentage test in relation to operating assets may prove to be a valuable rule of thumb.

other changes in the operating assets which might give the surviving corporation the appearance of a new business appear to be of importance in determining whether "substantially all" the assets were transferred. In other words, one must examine and decide the extent of the carry-over of all the attributes of the liquidating corporation to the new corporation and place values on each item relative to its importance to the continuation of the business of the disappearing corporation. After this is accomplished, then one must determine whether "substantially all" the attributes of the liquidating corporation appear in the new corporation. If the answer is affirmative, then the "substantially all" requirement of section 354 (b) (1) (A) will have been met.⁸⁰

Indicative of the approach taken by the Tax Court is the *James Armour, Inc.*⁸¹ case. In *Armour*, the transferor had assets with a fair market value of about \$1,230,000. Of this amount only \$620,774.98 (representing construction equipment owned by transferor) and \$7802.84 (which represented the value of furniture, fixtures, and automobiles) were transferred to the surviving corporation. A building having a value of \$109,030.00 and a lease from the sole shareholder of each corporation having a book value of \$70,410.46⁸² were not transferred to the successor corporation but were distributed to the shareholders who thereafter leased the property to the successor corporation.⁸³ The Tax Court in finding that "substantially all" the assets were transferred within the meaning of section 354(b)(1)(A) stated: "Thus, it will be seen that as a result of the transactions Excavating [successor corporation] either acquired title to, *or the use of*, all the assets *essential* to the conduct of the business enterprise."⁸⁴ It should be noted that the Tax Court was not concerned with whether title to "substantially all" the necessary operating properties were transferred to the successor corporation. The Tax Court reviewed the operations of the successor corporation with a view to determining whether essentially the same business was being conducted with essentially the same facilities immediately after the liquidation and reincorporation as was conducted before that transaction. The Tax Court, therefore, in determining whether a transfer of "substantially all" the assets has occurred within the meaning of section 354 (b) (1) (A) will rest its decision upon the transfer of the use of the property rather than the transfer of both title and use.

80. Notably, the courts says that the test of "substantially all" depends on the facts of each case. In *Estate of Bernard H. Stauffer*, 48 T.C. 277 (1967), *rev'd*, 403 F.2d 611 (9th Cir. 1968), the Tax Court found a "D" reorganization notwithstanding its finding that there *had been a substantial change in the business* via the merger of three viable corporations. Thus, the concept of continuity does not mean that the business need exist in the identical manner as it did before the reorganization, but that its presence be clearly discernable in the new corporation. *See also James Armour, Inc.*, 43 T.C. 295 (1964).

81. 43 T.C. 295 (1964).

82. The balance of approximately \$425,000 was made up of cash and receivables used to pay creditors or distributed as part of the liquidation.

83. *Id.* at 309.

84. *Id.* at 309.

As a result of these two cases, it appears that "transfer" as used in section 354 (b) (1) (A) refers to the transfer of use as well as both title and use and that "substantially all" the assets refers mainly to operating assets.

It may be questioned whether these interpretations can be sustained on the basis that section 354 (b) (1) (A) merely presents a test of continuity and is therefore not to be literally interpreted. The case of *J. Jay Rommer v. United States*⁸⁵ represents an apt example of how the broad interpretation given to "substantially all" by the Tax Court could result in an inequitable use of the reorganization sections. In *Rommer*, as part of a plan of liquidation under section 337, the corporation sold a luxury apartment house (its only operating asset) in an arm's length transaction for approximately \$412,000 in cash and a tenement house with an equity value of \$40,000. A short time later, two of the three shareholders in the corporation formed a new corporation to which the tenement house was transferred. The balance of the assets were distributed to the shareholders pursuant to section 337. The Service assessed the stockholders for a deficiency stating that a liquidation-reincorporation had occurred and that the transfer of the tenement house to the new corporation constituted a "D" type reorganization within sections 354 (a) (1) and 368(a)(1)(D). It was clear that *immediately* preceding the transfer the only operating asset held by the liquidating corporation was the tenement house and that that asset was reincorporated. Therefore, it was argued that substantially all the assets were transferred and the business carried on before the transfer (the rental business) was being carried on afterwards by the successor corporation. If this position was accepted then the obvious result would be that section 337 would not apply to the original sale⁸⁶ and that section 356 would necessarily control the income characterization of the property received and retained by the shareholders.

The district court refused to accept the Service's approach and held that the initial sale of the luxury apartment to an outsider, in essence, terminated the business of the liquidating corporation and that the subsequent transfer of the tenement house was one of the several steps in the plan of liquidation under section 337 and was to be treated as such.⁸⁷ The court answered the Service's argument that "substantially all" the assets were transferred within the meaning of section 354(b)(1)(A) in that the only operating assets, namely the tenement house, was transferred to the new corporation by stating: "To view this conveyance as a transfer of 'substantially all' [the] assets, *borders on the frivolous.*"⁸⁸

85. 268 F. Supp. 740 (D.N.J. 1966).

86. See pp. 439-40 *infra*, where the cases of Retail Properties, Inc., 23 CCH Tax Ct. Mem. 1463 (1964), and Ralph C. Wilson Sr., 46 T.C. 334 (1966), are discussed.

87. 268 F. Supp. at 745.

88. *Id.* at 744.

The obvious error in the Service's position was the failure to group all those factors which were part of the single overall plan of the corporation under one roof. Thus, the Service improperly excluded from consideration the initial sale of the luxury apartment, the rental of which constituted the business of the corporation immediately preceding the series of transactions in question. Once it is established that the liquidating corporation was in the business of renting a luxury apartment and that the new corporation was in the business of renting a tenement house then it is quite clear that the transaction, viewed as a whole, lacked the continuity which formed the heart of the Tax Court's interpretation of "substantially all" in *Moffatt* and *Armour*. This case is indicative of one of the pitfalls arising from the Tax Court's interpretation of "substantially all." There are, as of now, no clear standards to guide the taxpayer in determining what factors should or should not be considered, and thus, the predictability of treatment of any given set of facts is lacking.⁸⁹

Another problem related to the "substantially all" test arises from the possible effect of finding a "D" type reorganization on sales of property to outsiders by the corporation in reliance upon the non-recognition provisions of section 337. To illustrate, the facts in the *Retail Properties, Inc.*⁹⁰ case should be considered in light of the holding in the *Ralph C. Wilson, Sr.*⁹¹ case.

In *Retail Properties, Inc.* the transferor sold four of its five rental properties to a wholly owned subsidiary and the other property was sold to an outsider. These sales were made pursuant to a plan of complete liquidation under section 337 and therefore no gain or loss was reported by the transferor and the shareholders reported either a capital gain or loss under 331 upon distribution of the assets. The Tax Court, however, found that "the assets transferred were ample to accomplish the continuance of the rental business petitioner had carried on before the transferor."⁹² Therefore, the transaction was held to fall within section 354(b)(1)(A), notwithstanding the fact that shares of stock of the transferee-subsiary (having a value in excess of the transferred properties held by the transferor) were not included in the transfer of assets to the subsidiary corporation.⁹³

In *Ralph C. Wilson, Sr.*⁹⁴ the Tax Court, after finding that all the assets that were necessary or *appropriate* to the conduct of the business of Associates (the liquidating corporation) were transferred to Agency (the new corporation) held that "section 337(a), like section 331, is inap-

89. The question of excluding and including various steps in a series of transactions permeates this entire area of taxation. See pp. 443-46 *infra*.

90. 23 CCH Tax Ct. Mem. 1463 (1964).

91. 46 T.C. 334 (1966).

92. 23 CCH Tax Ct. Mem. 1463, 1472 (1964).

93. *Id.*

94. 46 T.C. 334, 345 (1966).

plicable, since there was no 'complete liquidation' of Associates."⁹⁵ Therefore, where some assets are sold to outsiders, as occurred in *Retail Properties, Inc.*, the gain on such a sale will not receive the non-recognition benefits of section 337(a) but will be subject to the provisions covering the sale of these particular type of assets.⁹⁶ Additionally, this amount will necessarily increase the earnings and profits account of the liquidating corporation thereby expanding the possible effect of section 356(b) treatment of "boot." It would therefore appear to be appropriate when a liquidation-reincorporation is contemplated that assets, which will not be either transferred to or placed at the disposal of the new corporation, be distributed in kind and sold by the shareholders, thereby avoiding to some extent the composite effect of losing section 337 treatment. Moreover, when planning a liquidation-reincorporation transaction the planner should seriously consider distributing in kind not only the liquid assets of the business but also all operating assets which may not be necessary to the continuing conduct of the trade or business as well as those assets which may be obsolete and need to be replaced. By doing so, one may be placed in a better position to argue that "substantially all" the operating assets were not transferred or placed at the disposal of the successor corporation. However, if one is faced with the situation where some assets are sold to outsiders by the corporation then he might argue that, unless a section 337 liquidation was contemplated by the parties, no one would risk running afoul of the effect of the non-recognition provisions when he could just as easily distribute the assets and then sell them.⁹⁷ However, this would be a boot strap argument at best and should not be relied on except under extremely difficult circumstances.

2. *Transfer of Securities Pursuant To a Plan of Reorganization*

Under the provisions of section 354(a)(1) no gain or loss shall result from a transaction where "stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization."⁹⁸ From this language it would appear that unless securities or stock are transferred pursuant to a plan of reorganization the transaction would fail to fall within its provisions thereby removing the transaction from the operation of section

95. *Id.* at 352.

96. The amount of gain or loss and its characterization will depend on whether it is a capital or non-capital asset (*see* INT. REV. CODE of 1954, § 1231) and if it is the former then a question arises as to the applicability of the "recapture provisions." INT. REV. CODE of 1954, §§ 1245, 1250.

97. *But see* Court Holding Co., 324 U.S. 331 (1945). For a full discussion of the problems that arise in this type of transaction, see B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS § 5.21, at 181-82 & n.76 (2d ed. 1966).

98. INT. REV. CODE of 1954, § 354(a)(1).

368(a)(1)(D). On several occasions the Tax Court was called upon to determine whether this result would be forthcoming in a reincorporation transaction where stock or securities were not transferred.

In *James Armour, Inc.*⁹⁹ the court was faced with a situation where the liquidating and successor corporations were, immediately before the series of transactions, in a brother-sister relationship. Therefore, there was no need for the successor corporation to transfer any of its securities or stock either to the liquidating corporation or directly to its shareholders in order to maintain continuity of ownership. The court answered the argument that the provisions of section 354(a)(1) were not met by stating: "The issuance of further stock would have been a meaningless gesture, and we cannot conclude that the statute requires such a vain act."¹⁰⁰ The court has persisted in this position¹⁰¹ and there would appear to be little value in structuring a transaction in such a way as to hopefully avoid reorganization treatment by excluding as part of the transaction the exchange or transfer of stock or securities.

A somewhat related problem was posed by the *Reef Corp.*¹⁰² case where the shareholders conveyed all their stock in the liquidating corporation to a "strawman" for cash and personal notes. By doing this the shareholders were attempting to structure their transaction so that the stock or securities which they held in the successor corporation could not be used to determine whether they, as shareholders in the liquidating corporation, had control of the successor corporation immediately after the transfer as required by section 368(a)(1)(D).¹⁰³ That is to say, for purposes of section 368(a)(1)(D) they were not shareholders in the liquidating corporation immediately preceding the transfer of the assets by the liquidating corporation and therefore their stockholdings in the successor corporation could not be used to determine control. The Tax Court ignored the sale to the strawman and found that in fact the transferees maintained ownership of the stock.

When the position of the Tax Court is analyzed as to each attempt to frustrate the imposition of reorganization treatment, it is clear that it will proceed beyond the mere superficial structure of any transaction and draw upon only those facts which form the substance of the transaction. Thus, it would seem to be a fruitless use of legal gymnastics to structure any liquidation-reincorporation in a way such as was done above

99. 43 T.C. 295 (1965). See also *Commissioner v. Morgan*, 288 F.2d 676 (3d Cir. 1961), *rev'g* 33 T.C. 30 (1959), *cert. denied*, 368 U.S. 836 (1961).

100. 43 T.C. at 307.

101. *E.g.*, *South Texas Rice Warehouse Co.*, 43 T.C. 540, 568-69 (1965), *rev'd on other grounds sub nom. J.E. Davant v. Commissioner*, 366 F.2d 874 (5th Cir. 1966); *Ralph C. Wilson, Sr.*, 46 T.C. 334, 344 (1966).

102. 24 CCH Tax Ct. Mem. 379 (1965), *aff'd*, 368 F.2d 125 (5th Cir.), *cert. denied*, 386 U.S. 1018 (1966). For further discussion of this case, see p. 450 *infra*.

103. 24 CCH Tax Ct. Mem. at 393.

so as to avoid the technical requirements of sections 354(a)(1) or 368(a)(1)(D),¹⁰⁴ but to comply with the theory and purpose of the reorganization provisions.¹⁰⁵

3. Control Requirement and *Gallagher* — Separating the Transaction

Section 368(a)(1)(D) provides that in order to have a reorganization "immediately after the transfer the transferor or one or more of its shareholders . . . or any combination thereof, is in control of the corporation to which the assets are transferred . . ." ¹⁰⁶ Whether a shareholder or a combination of shareholders are in control of a corporation will, in turn, depend upon a finding that either as individuals or in combination they own "stock possessing at least 80 per centum of the total combined voting power of all classes of stock entitled to vote and at least 80 per centum of the total number of shares of all other classes of stock of the [surviving] corporation."¹⁰⁷

In *Joseph C. Gallagher*¹⁰⁸ the Tax Court was faced with the question whether a failure to meet this requirement would prevent the imposition of reorganization treatment in a liquidation-reincorporation setting. The Commissioner did not argue that a "D" type reorganization had occurred. However, the Tax Court noted that his failure to press this argument was probably "because only 72 $\frac{2}{3}$ percent of California's stock [the new corporation] was owned by former shareholders of Delaware [the disappearing corporation]."¹⁰⁹

If there was any question as to the Tax Court's opinion on this issue, it was clearly removed in the *Hyman H. Berghash*¹¹⁰ case. In *Berghash*, the one shareholder "who owned 198 out of the 200 outstanding shares of the old corporation (the remaining 2 shares being held by his wife), acquired only 50 percent of the outstanding common stock of Dorn's Drugs, Inc. [the new corporation] . . ." ¹¹¹ The Tax Court stated that: "In the situation here presented it is impossible to view the result as a (D) reorganization because of the *conspicuous* failure of the transaction to qualify under the 'control requirements' of subparagraph (D) and section 368(c)."¹¹²

An interesting sidelight of the *Berghash* case was the fact that the sole shareholder in the old corporation held an option to purchase the

104. From this it could be said that the reorganization sections are not really elective but that the transaction will fall within them if it falls within their intended purpose. Cf. *Gregory v. Helvering*, 293 U.S. 465 (1935).

105. *But see* pp. 446-52 *infra*.

106. INT. REV. CODE OF 1954, § 368(a)(1)(D).

107. INT. REV. CODE OF 1954, § 368(c).

108. 39 T.C. 144 (1962), *acquiesced in result only*, 1964-2 CUM. BULL. 5.

109. *Id.* at 161. Contrast this strict interpretation of "control" as one of the technical requirements of finding a reorganization with the Tax Court's liberal interpretive approach to other technical requirements. *See* pp. 436-42 *supra*.

110. 43 T.C. 743 (1965), *aff'd*, 361 F.2d 257 (2d Cir. 1966).

111. *Id.* at 755-56.

112. *Id.* at 755 (emphasis added).

other 50 percent stock interest in the new corporation held by the new shareholder. As to the possibility that the old shareholder might, in the future, acquire total ownership of the new corporation, the Tax Court noted that the attribution rules of section 318 were not incorporated into section 368(c)¹¹³ and that "[t]he existence of an *unexercised* option has been held to be of no consequence in determining control for corporate reorganization purposes."¹¹⁴ The obvious question arising from this language, and as yet unanswered, is whether an option which is exercised a short time following the reorganization would meet the "*immediately* after the transfer" language of section 368(a)(1)(D).¹¹⁵

4. *Step Transaction Doctrine*

The rationale implicit in the Tax Court's holdings in the "D" reorganization cases is that once various steps in a transaction are viewed as a whole in order to determine whether a plan of reorganization exists, one cannot segregate out certain parts of the total transaction for the purposes of analyzing specific issues. This position, quite clearly, is contrary to that taken by the Service in Rev. Rul. 61-156¹¹⁶ and Treas. Regs. §§ 1.301-1 and 1.331-1 (c). The resolution of this conflict necessarily depends on the view taken of the operation of the "step transaction" doctrine and its application to a liquidation-reincorporation transaction. Generally, there are two ways in which the step transaction doctrine has been stated by the courts. First, the doctrine is referred to in terms of "the intended end result." This test requires one to "examine the situation as it existed at the beginning and end of a series of steps and the object sought to be accomplished . . ."¹¹⁷ The doctrine has also been couched in terms of a "mutually interdependent steps" theory. This test requires one to take a series of transactions and determine which steps "are so interdependent that the legal relations created by them would have been fruitless without a completion of the series."¹¹⁸ The effect of using the step transaction doctrine is to apply the Code on the basis of the cumulative effect of all the individual steps ignoring the independent significance of each step.

The Service, in its revenue ruling,¹¹⁹ attempts to split off those transactions which are not necessary to the finding of a reorganization

113. *Id.* at 757.

114. *Id.* at 758 (emphasis added).

115. If such a situation arises, the court will probably ignore the existence of the option in the same manner as it ignored the transfer of all the shares to a "strawman" in Reef Corp., 24 CCH Tax Ct. Mem. 379 (1964). See p. 441 *supra*. Therefore, control within the meaning of section 368(c) will have been met and the transaction would probably qualify as a "D" type reorganization.

116. 1961-2 CUM. BULL. 62.

117. Grubb, *Corporate Manipulations Under Subchapter C: Reincorporation — Liquidation*, 28 U. CIN. L. REV. 304, 306-07 n.4 (1959). See also James Armour, Inc., 43 T.C. 295, 305 (1964). See also Lipkind, *Gallagher Revisited: The Functionally Unrelated Corporate Reorganization*, 13 VILL. L. REV. 487, 521-23 (1968).

118. Grubb, *supra* note 61, at 306-07 n.4. See also Joseph C. Gallagher, 39 T.C. 144, 156 (1962), *acquiesced in result only*, 1964-2 CUM. BULL. 5.

and treat those as separate and distinct for tax purposes. Thus, in a case such as *Gallagher*¹²⁰ the Service would treat as separate and distinct transactions the removal of the shareholders from the old corporation (redemption out) and the issuance of stock in the new corporation to the new shareholders (new issuance). As a result of this, there would be a 100 percent continuity of proprietary interest from the old to the new corporation. Additionally, the Service, vis-à-vis the implementation of its regulations, will take certain steps and restructure them as they might have occurred absent the reorganization, when such steps were used solely for "tax avoidance purposes"¹²¹ (*i.e.*, devoid of a valid *business purpose*). Once it is found that the balance of the transactions had no business purpose, the Service will then proceed to apply what in effect is a form versus substance test. By doing this, the series of transactions would be restructured to find a dividend with respect to the stock of the old corporation under section 301.

The inherent problem with this approach is that the distribution flows from a corporation which is no longer in existence and would therefore appear to be a clear section 331 liquidating distribution and should properly be treated as such. The Service, in order to avoid section 331 treatment, must ignore the fact that there exists two very separate and distinct taxable entities as recognized by the Code and find, in substance, that there is only one.¹²² The Service, however, has not been consistent even on the point of ignoring the fact that two corporations exist as evidenced by Rev. Rul. 61-156 where, after finding a section 301 dividend, they held that either an "E" or "F" type reorganization has occurred. The "F" type reorganization clearly requires two separate corporations¹²³ and thus clearly conflicts with the prior position that there is only one corporation. There would appear to be two reasons for this inconsistent approach. First, the Service may be unsure of its position ignoring the existence of two corporations and thus the concomitant liquidation and reincorporation. Second, it may be pressing reorganization treatment for fear that the court may be unable or unwilling to implement the carryover of certain corporate attributes¹²⁴ to

120. Joseph C. Gallagher, 39 T.C. 144 (1962), *acquiesced in result only*, 1964-2 CUM. BULL. 5.

121. When Treas. Reg. §§ 1.331-1(c) and 1.301-1 are read in conjunction with Rev. Rul. 61-156 it appears that the Service will attempt to impose complete dividend treatment under the regulation on any distributions flowing from a liquidation-reincorporation where tax avoidance was a principal motivating factor for structuring the transaction in this form.

122. For a discussion of ignoring the liquidation as a possible solution to the reincorporation problem, see pp. 458-61 *infra*.

123. The traditionally "F" type reorganization will involve an active business which is merging into a newly established corporate shell. Therefore, there necessarily will be two corporations involved in any "F" type reorganization. Additionally, in *James Armour, Inc.*, 43 T.C. 295, 305 (1964), the court stated: "It is well settled that the liquidation of a corporation may be merely a step in a reorganization." See also *Hyman A. Berghash*, 43 T.C. 743, 755 (1965), *aff'd* 361 F.2d 257 (2d Cir. 1966).

124. Section 381 provides for the carryover of corporate attributes between parties to a reorganization and this section has also been applied when a reorganization has

the successor corporation absent a reorganization. However, if the court were willing to ignore the existence of the two corporations for the purposes of section 301, there would appear to be no reason not to continue this approach when faced with the issue of carryover of corporate attributes.¹²⁵ That is to say, if there is, in substance, only one corporation then how could there be any question of carryover. It would appear that the uncertainty of the Service's position was probably the motivating factor behind the ruling that either an "E" or "F" reorganization had occurred on the basis of the facts submitted for the ruling.

A very plausible argument could be made in support of the Service's position with respect to treating the transactions as if only one corporation exists. The Service may point to the fact that the liquidation-reincorporation, when viewed as a whole, is a device for bailing-out earnings unsupported by a valid business purpose within the framework of *Gregory v. Helvering*.¹²⁶ Once this is accepted then the Commissioner may restructure the transaction to properly reflect what has occurred for the purposes of taxing the transaction.

The Tax Court has not been willing to accept this argument. Instead, they persist in trying to plug the liquidation-reincorporation loophole with the reorganization provisions of the Code. Once this position is taken by the court, it will then proceed to group the series of transactions into one refusing to segregate any steps of the series which they feel is a part of the plan of reorganization. If the composite effect of the series of events is not a reorganization then they will treat the transaction as a valid liquidation under section 331 and reincorporation under section 351. However, beyond the Tax Court, the Service has met with some success. The Fifth and Ninth Circuits, in a series of recent cases,¹²⁷ has been willing to fragment a series of transactions in line with the approach of Rev. Rul. 61-156 and thereby find that an "F" type reorganization has taken place where there was a change in proprietary interest and where two going corporations merged. The use of the "F" type reorganization by the Fifth and Ninth Circuits necessarily will require some discussion as to how they apply its provisions and

been found to exist. Therefore, absent any statutory authority for the forced carryover of corporate attributes, a court may be reluctant to impose such treatment. In Joseph C. Gallagher, 39 T.C. 144 (1962), *acquiesced in result only*, 1964-2 CUM. BULL. 5, the Tax Court expressed this feeling when it said:

The basic approach of the complicated series of enactments incorporated in the 1954 Code appears to be that all such situations are to be tested by the "reorganization" portion of the statute, and that . . . if a transaction of a similar kind does not fall within them . . . it shall be treated as a transaction giving rise to gain or loss and not as a distribution.

Id. at 157-58.

125. See pp. 446-49 *infra* where the Fifth Circuit in *Davant v. Commissioner*, 366 F.2d 874 (5th Cir. 1966), *aff'g in part and rev'g in part* *South Texas Rice Warehouse Co.*, 43 T.C. 540 (1965), *cert. denied*, 386 U.S. 1022 (1966) did, in effect, ignore the existence of the two corporations to find a dividend to the extent of the earnings and profits of both parties to the reorganization.

126. 293 U.S. 465 (1934).

127. See pp. 446-52 *infra* for a complete discussion of these cases.

why they disagree with the Tax Court on this point and the ramifications of the use of the "F" reorganization as to other aspects of the reorganization transaction.

C. "F" Type Reorganization

Section 368(a)(1)(F) defines as a reorganization a transaction where a "mere change in identity, form, or place of organization of a corporation however effected"¹²⁸ has been carried out by the taxpayer. Until recently, this type of reorganization was little used and was generally felt to cover relatively few corporate rearrangements.¹²⁹ The first application of subsection (F) to a liquidation-reincorporation occurred in the *Pridemark, Inc.*¹³⁰ case. In *Pridemark* the Tax Court held that an "F" reorganization had taken place where brother-sister corporations were liquidated and, after the lapse of a period of time, the major assets were reincorporated into one corporation. On appeal, the Fourth Circuit reversed the Tax Court¹³¹ on this issue stating that "[T]he facts of this case do not bring it within the 'reincorporation' area because the transactions were not motivated by a desire to avoid the payment of taxes."¹³² The court then held that "[s]ince there is a complete liquidation . . . within the meaning of sections 331 and 337, the distributions to the shareholders are entitled to be treated as a redemption of stock and taxed as a capital gain."¹³³ In subsequent cases the Tax Court refused to follow its decision in *Pridemark* and found that an "F" reorganization could not occur where two or more businesses are liquidated and reincorporated into one corporate form since "substantial changes [*i.e.*, not a "mere change"] did occur when the separate businesses . . . were united in a new corporation."¹³⁴

Decisions rendered by the Fifth Circuit, on appeals from the Tax Court, applied the holding of *Pridemark* and, as of now, have not reversed their position. The case of *J. E. Davant v. Commissioner*¹³⁵ was the first of these cases where the Fifth Circuit found that either a "D" or "F" reorganization¹³⁶ had occurred where there was a liquidation of a "going concern" and a later reincorporation of its assets into another "going concern" which was wholly owned by the same shareholders. The

128. INT. REV. CODE OF 1954, § 368(a)(1)(F).

129. See, e.g., Lipkind, *Gallagher Revisited: The Functionally Unrelated Corporate Reorganization*, 13 VILL. L. REV. 487, 500-04 (1968).

130. 42 T.C. 510 (1964).

131. *Pridemark, Inc. v. Commissioner*, 345 F.2d 35 (4th Cir. 1965).

132. *Id.* at 41 (emphasis added). One consideration for this finding might have been that "there was no testimony that the stockholders were under any legal or moral compulsion to reconvey their assets . . ." *Id.* at 38. See pp. 428-31 *supra* for a discussion of decisions rendered against the finding of a reorganization under the 1939 Code.

133. *Id.* at 42.

134. *Estate of Bernard H. Stauffer*, 48 T.C. 277, 300 (1967), *rev'd*, 403 F.2d 611 (9th Cir. 1968).

135. 366 F.2d 874 (5th Cir. 1966), *aff'g in part and rev'g in part* South Texas Rice Warehouse Co., 43 T.C. 540 (1965).

court then went on to hold that the distribution of the liquid assets was "functionally unrelated" to the reorganization and that they were to be treated as a dividend under section 301.¹³⁷ The extent of the dividend treatment was the combined earnings and profits of both parties to the reorganization.¹³⁸ By reaching this result, the court was apparently adopting the approach of Rev. Rul. 61-156 and Treas. Regs. §§ 1.301-1 and 1.331-1(c). Contrary to the position of the Tax Court, the Fifth Circuit took the approach that not all steps from the beginning to the end of a series of transactions need fall within the plan of reorganization as a result of using the step transaction doctrine. Rather, the court looked at the series of transactions to determine which were "functionally related" and grouped those separately from those not found to be "mutually interdependent."¹³⁹ Therefore, it was found that the distribution of the liquid assets did not depend on the use of a reorganization and, conversely, that the reorganization of the two corporations did not necessitate the distribution of liquid assets. However, the court went beyond segregating the distribution of the liquid assets from the reorganization and found that the extent of the dividend was to be determined by the earnings and profits of both corporations who were parties to the reorganization.¹⁴⁰ In effect, the court probably felt that the reorganization was no more than a vehicle for disguising a dividend from the successor corporation to the shareholders who owned both parties to the reorganization.¹⁴¹ Therefore, it would appear that the Fifth Circuit will run into the same problems as the Service with its Revenue Ruling in that in order to reach its result it must find that throughout the series of transactions in issue only one corporation existed for tax purposes.¹⁴²

This appears to be the position taken by the Fifth Circuit in *Davant* as evidenced by the following: "Water [the successor corporation] and Warehouse [the liquidating corporation] were but different pockets in

137. *Id.* at 888. The court held that the \$700,000 petitioners received from Water and the \$200,000 petitioners received from Warehouse were dividends under section 301 declared incident to a reorganization.

138. *Id.* at 889. The court stated: "Where there is complete identity of stockholders the use of the earnings and profits of both corporations is the only logical way to test which distributions have the effect of a dividend."

139. Functionally unrelated and mutually interdependent would appear to be two sides of the same step transaction coin. However, the Tax Court and Fifth Circuit disagree as to whether certain transactions which occur simultaneously with other steps, which taken alone may constitute a reorganization, may be grouped separately. See pp. 443-44 *supra* as to the Tax Court's approach.

140. The Fifth Circuit answered the question of the applicability of the language "the corporation" in section 356 to the transaction in the following manner in *Davant v. Commissioner*, 366 F.2d 874, 889 (5th Cir. 1966):

It would be illogical to say that \$700,000 would be used to measure how much of the \$900,000 distribution had the effect of a dividend if Water were merged into Warehouse and only \$200,000 should be used to measure how much of the \$900,000 distribution had the effect of a dividend just because Warehouse was merged into Water.

141. *Id.* at 889. The court said that "Warehouse was a conduit for Water's distributions of \$700,000 . . ." *Id.*

142. See p. 444 *supra*.

the *same* pair of trousers worn by petitioners.”¹⁴³ Therefore, where a reorganization occurs between brother-sister corporations any distributions as a result of the reorganization will be treated as if a dividend was paid by the undivided whole ignoring each legal piece of the corporate group.¹⁴⁴ That is, in substance, the dividend came from the commonly controlled group although on a pure formalistic approach no dividend could have flowed from the successor corporation’s earnings and profits as a result of the reorganization.

Although Rev. Rul. 61-156 appears to take the same avenue to find that a section 301 dividend has occurred, the *Davant* case went further to find that there was a dividend to the extent of the earnings and profits of *two* going corporations. The revenue ruling was concerned with a situation where there was only *one* “going concern” and only *one* earnings and profits account and whether the Service would carry its position to the extreme of *Davant* is not entirely clear.¹⁴⁵

Once the analysis of the court is accepted as to the finding of a section 301 dividend to the extent of the combined earnings and profits, further questions arise as to why it is necessary to find a reorganization¹⁴⁶ and why the court adopted both the “D” and “F” type reorganizations. The first question seems to be answered by the court’s reluctance to break new ground by treating what was previously treated as two separate and distinct taxable entities as one during these series of transactions without finding a reorganization of some type. That is, no court has gone so far as to say that when there are two “going concerns” under common control that in form there may be two corporations, but in substance there is only one.¹⁴⁷ In the cases presented, the problem is not one combining two going corporations which have not “in form” been combined. Rather, the problem is that the form of the series of transactions is such as to create one corporation which prior to these transactions were “in substance” one corporation and that any distributions during this period were to be considered as coming from both corporations. Therefore, it would be unnecessary to find that a reorganization has occurred but for the formalistic necessity of such a finding under the Code.

The Code has continually recognized the existence of corporations as separate taxable entities and has not conditioned the finding of what

143. 366 F.2d 874, 889 (5th Cir. 1966) (emphasis added).

144. *Casco Prods. Co.*, 49 T.C. 32 (1967).

145. From the recent cases of *Estate of Bernard H. Stauffer*, 48 T.C. 277 (1967), *rev'd*, 403 F.2d 611 (9th Cir. 1968) and *Associated Machine*, 48 T.C. 318 (1967), *rev'd*, 403 F.2d 622 (9th Cir. 1968), it appears that the Service will not press the *Davant* holding that an “F” reorganization can take place between two viable corporations.

146. The court ignored the two corporate forms for the purpose of finding a section 301 dividend and there would appear to be no reason why the same approach could not be taken as to the balance of the transactions and find that, in substance, these were a series of transactions involving but one taxable entity.

147. See *Estate of Bernard H. Stauffer*, 48 T.C. 277, 298 (1967), *rev'd on other grounds*, 403 F.2d 611 (9th Cir. 1968), where the Tax Court rejected this contention when made by the petitioner.

is a corporation on any "in substance" requirement.¹⁴⁸ Therefore, more for the purposes of form than substance, it becomes necessary to find a reorganization under the provisions of the Code. Otherwise, in form, a sale and liquidation has occurred which necessarily would conflict with any theory that these two corporations were, in fact, one. That is, the court will require both "in form" and "in substance" one corporation before it could possibly find a dividend to the extent of the earnings and profits of both corporations as they existed prior to the series of transactions in question. If this were not the case, then by applying a form versus substance test to *any dividend of commonly controlled companies* it would appear that a dividend would be determined to the extent of the earnings and profits of both corporations. Therefore, the "in substance" section 301 dividend to the extent of the earnings and profits of both corporations can only occur when there is "in form" a series of transactions amounting to a reorganization.

After it is found that a reorganization is required in order to combine earnings and profits to determine the extent of the dividend, the obvious question is what type of reorganization must be found or is it relevant at all which type is found. The court in *Davant* felt that whether the reorganization was a "D" or "F" type was inconsequential.¹⁴⁹ It is submitted that, if the rationale of the *Davant* opinion is accepted, whether a "D" or an "F" type reorganization is found to have occurred should be immaterial. However, the rationale of the court's opinion would more easily fit within the theory of an "F" reorganization than a "D". The court's opinion could be considered as expanding the concept of "sameness"¹⁵⁰ in the "F" situation to cover reorganizations within a commonly controlled group of corporations.

In *Davant*, the fact considered to be critical by the court was the "in substance" uniformity of the corporations before and after the series of transactions amounting to a reorganization. However, the court's finding of an "F" reorganization where *two going* corporations are the parties to the reorganization goes beyond what is normally felt to be an "F" type reorganization. In fact, the Service in Rev. Rul. 61-156 has not gone this far in that it found an "F" reorganization where there was a transfer of assets from a *going concern* to a new corporate shell.

148. That is to say, that where there are two viable corporations in distinct businesses which are under common control have not been treated as one taxable entity. See *Associated Mach.*, 48 T.C. 318, 327 (1967), *rev'd on other grounds*, 403 F.2d 622 (9th Cir. 1968).

149. In that the dividend was separate from the reorganization its character and extent would not be controlled by the type of reorganization involved. That is, whether a "D" or "F" type reorganization was found would not affect that decision under the court's rationale.

150. See *Hyman H. Berghash*, 43 T.C. 743, 752 (1965), *aff'd*, 361 F.2d 257 (2d Cir. 1966). That is, "sameness" would be put in relation to the group not the individual taxable corporate entities.

In the subsequent case of *Reef Corp. v. Commissioner*¹⁵¹ the same court found that an "F" reorganization had occurred where there was a 48 percent change in shareholder ownership. In *Reef* the court was faced with the transfer of assets by a going concern to an inactive corporate shell.¹⁵² However, as a result of the series of transactions 48 percent of the shareholders in the liquidating corporation disappeared while the remaining 52 percent had acquired 100 percent ownership of the new corporation.¹⁵³ The court viewed the change in ownership as a "functionally unrelated" redemption of stock wholly separate from the reorganization.¹⁵⁴ Once this aspect of the transaction was removed the court had little trouble in finding 100 percent continuity of ownership and business operations with the resulting consequence of finding an "F" reorganization.

When *Reef* and *Davant* are considered together, it becomes clear that the Fifth Circuit has adopted the position of the Service in Rev. Rul. 61-156 as to the treatment of "boot" received as a 301 dividend and the siphoning off of any change in ownership from the plan of reorganization.¹⁵⁵ It is also clear from *Davant* that they have even gone further than the revenue ruling by finding an "F" reorganization where two going concerns are the parties to the reorganization and by combining the earnings and profits of *both* corporations to determine the extent of the 301 dividend. In effect, the Fifth Circuit has prevented any degree of earnings bail-out through the use of the liquidation-reincorporation transaction.¹⁵⁶

In cases arising in the Tax Court subsequent to *Davant* and *Reef* it is clear that the Fifth Circuit by extending the effect of the revenue ruling to the combination of two going concerns has created significant problems in the application of section 381(b).¹⁵⁷ Section 381(b) provides for the carryback of a net operating loss to pre-reorganization earnings if that reorganization was of the "F" variety. In *Estate of Bernard H. Stauffer*¹⁵⁸ the Tax Court was confronted with a situation where three commonly controlled companies were reorganized into one corporation. In the year subsequent to the reorganization the successor corporation sustained a net operating loss which it wished to carryback to pre-reorganization earnings. Petitioner based his argument for allow-

151. 368 F.2d 125 (5th Cir.), *cert. denied*, 386 U.S. 1018 (1966), *rev'g* 24 CCH Tax Ct. Mem. 379 (1965).

152. Thus, there was no question, as in *Davant*, as to what would be the extent of the dividend.

153. *But see* *Helvering v. Southwest Consol. Corp.*, 315 U.S. 194 (1941).

154. 368 F.2d at 134.

155. *See* pp. 443-44 *supra*.

156. *See* note 140 *supra* where the *Davant* court indicated the potential earnings bail-out possibilities by the mere choice of which going concern should be merged into the other.

157. INT. REV. CODE OF 1954, § 381(b).

158. 48 T.C. 277 (1967), *rev'd*, 403 F.2d 611 (9th Cir. 1968). For a discussion of *Davant* and *Reef* and their effect on these cases, see Grossberg, *Type F Reorganization in the Fifth Circuit: The Mouse That Roared*, 5 HOUSTON L. REV. 926 (1968).

ance of the carryback on the theory that either one or three separate "F" type reorganizations had occurred thus bringing into operation section 381(b). The Tax Court refused to allow the carryback and held that a "D" rather than one or three "F" reorganization had taken place. The basis of the Tax Court's decision was that the merger of three going concerns into one inactive shell could not be considered a "mere change in form." The Tax Court viewed the consolidation as a change in the substance of the business on the theory that the character of any of the several businesses could not exist in the same manner after the consolidation as before it. That is, there is a complete change in capital structure along with an increase in the assets to which a creditor might look to satisfy his claims.¹⁵⁹ Additionally, there were significant changes in accounting and the complete disappearance of any inter-company sales and purchases. The Tax Court followed their position in *Stauffer* and refused to find an "F" reorganization in the subsequent *Associated Mach.*¹⁶⁰ case where one going corporation was merged into another active commonly controlled company. On appeal to the Ninth Circuit, both cases were reversed¹⁶¹ and the court found that an "F" reorganization had occurred using the reasoning of *Davant*.¹⁶² As a result of the court's holding, the net operating loss sustained by the surviving corporation in the years subsequent to the merger were allowed to be carried back pursuant to section 381(b). However, in *Stauffer*, the court specifically pointed out that the post-merger loss of the transferee company must be specifically apportionable to the present operations of the pre-merger identities in order to permit an apportioned amount of the transferee's loss to be carried back to the profitable operations of the pre-merger identities.¹⁶³ With this narrow holding the court must have found that three "F" reorganizations occurred and not one, for if in fact one had taken place it would not be necessary for the court to establish such stringent standards for the apportionment of the loss carryback. That is, if one "F" reorganization was found the loss of the transferee subsequent to the merger could be carried back with ease to the *combined* operations of the three pre-merger entities. It should be noted, therefore, that the court's analysis results in an anomaly in that to find that an "F" reorganization has occurred it viewed the total enterprise — identity of ownership and of business operations — while to apportion the loss carryback, it viewed components of the reorganization separately.

Though analytically difficult to justify, the Ninth Circuit has achieved an equitable result by relying on the reasoning of *Davant*. Although more

159. *Id.* at 300-01.

160. 48 T.C. 318 (1967), *rev'd*, 403 F.2d 622 (9th Cir. 1968).

161. Estate of Bernard H. Stauffer v. Commissioner, 403 F.2d 611 (9th Cir. 1968), *rev'g* 48 T.C. 277 (1967); Associated Mach. v. Commissioner, 403 F.2d 622 (9th Cir. 1968), *rev'g* 48 T.C. 318 (1967).

162. Estate of Bernard H. Stauffer v. Commissioner, 403 F.2d 611, 618-21 (9th Cir. 1968); Associated Mach. v. Commissioner, 403 F.2d 622, 624 (9th Cir. 1968).

163. Estate of Bernard H. Stauffer v. Commissioner, 403 F.2d 611, 622 (9th Cir. 1968).

than one going concern was involved in this "F" reorganization it is not illogical to say that a loss carryback should be permitted on this factual posture and, in fact, the Tax Court has recognized a similar result in *Casco Prods. Co.*¹⁶⁴ There, the court skirted the question of whether an "F" reorganization occurred when there was a nine percent change in shareholder interest, and held that a loss carryback was permissible since the essence of the corporations involved was the same before and after the restructuring.¹⁶⁵

In comparing these cases with *Davant*, it is clear that the Ninth Circuit at least partially concurs with the Fifth Circuit's view of an "F" reorganization. Although the Ninth Circuit recognizes that the merger of more than two going concerns can constitute an "F" reorganization, it is not clear from these opinions whether the Ninth Circuit will fall in line with the Fifth Circuit's "functionally unrelated" analysis as applied to the reincorporation area.

IV. SOLUTIONS TO THE REINCORPORATION PROBLEM

The previous discussion clearly demonstrates the inadequacy of fighting "reincorporations" with weapons that were not designed to thwart tax avoidance schemes. The consequences of a "D" reorganization can easily be avoided if the taxpayer fails to meet the 80 percent control requirement of section 368(c). Since the "F" reorganization in the great majority of circuits requires a 100 percent continuity of shareholder interest,¹⁶⁶ it can be by-passed with even greater ease. Furthermore, the Commissioner has only caused confusion as to what constitutes a "D" or an "F" type reorganization by attempting to bring reincorporations within their purview.¹⁶⁷ It is suggested, therefore, that this method of achieving an earnings bail-out should be controlled either through a specific statutory amendment or by cutting through the form of these transactions to their substance. Although the scope of this Comment does not permit a comprehensive statutory proposal, a format for the solution of this problem will be set forth after a discussion of other suggestions designed to correct this deficiency in the Code.

A. 1954 House Proposal

As noted above, the House version of the 1954 Code included a section designed to eliminate the reincorporation problem. Although it was never enacted, an analysis of its provisions reveals certain positive and negative aspects of this version of the statute which must be kept in mind in proposing any solution to this problem.

164. 49 T.C. 32 (1967).

165. *Id.* at 36-37.

166. *E.g.*, *Newmarket Mfg. Co. v. United States*, 233 F.2d 493 (1st Cir. 1956), *cert. denied*, 353 U.S. 983 (1957); *Cushman Motor Works v. Commissioner*, 130 F.2d 977 (8th Cir. 1942), *cert. denied*, 318 U.S. 756 (1943). See also p. 446 *supra*.

Section 357¹⁶⁸ generally provided that when shareholders in control of a corporation receive assets on complete or partial liquidation and within 5 years thereof transfer at least 50 percent of the assets, exclusive of money and other securities, to another corporation pursuant to section 351, the fair market value of the assets *not* so transferred shall be treated as a dividend to the extent of the earnings and profits of the original corporation.¹⁶⁹ In addition, the basis of the assets in the hands of the liquidated corporation would carryover to the second corporation.¹⁷⁰ However, these results would not occur unless a principal motive for effectuating such a transaction was to avoid assessing distributions of the liquidated corporation at ordinary income rates.¹⁷¹

The most glaring defect of this proposal was its inapplicability to the other methods available in the reincorporation context to achieve an earnings bail-out.¹⁷² The statute only covered that fact situation where the old corporation liquidated its assets in kind and the shareholders thereof retransferred them to a second corporation. As noted earlier, the sale of assets-liquidation and the pre-incorporation-liquidation devices would bring about substantially the same result, but the statute was obviously not intended to cover these devices. The question may well be asked why these schemes were eliminated from the scope of the statute. Although no answer is found in the legislative history, it is probably

168. H.R. REP. NO. 8300, 83d Cong., 2d Sess. 86 (1954). The section provided: Sec. 357. LIQUIDATION FOLLOWED BY REINCORPORATION.

(a) *General Rule.* — In any case in which one or more individuals receive assets in a complete or partial liquidation as defined in section 336 from a corporation controlled by such individual or individuals and within 5 years from the date of the final distribution in such liquidation transfer more than 50 percent of such (assets other than money and stock or securities (other than stock or securities representing an interest in the distributing corporation)) to one or more corporations controlled by one or more of such individuals in a transaction to which section 351 is applicable—

(1) the corporation to which any of such assets have been transferred shall be deemed to have received such assets from the liquidating corporation pursuant to a corporate acquisition of property within the meaning of section 359(c); and

(2) an amount equal to the fair market value of the assets received in liquidation not so transferred shall be deemed to have been received by the individuals in control of such other corporation or corporations as a distribution under section 352 pursuant to such corporate acquisition of property and such distribution shall be deemed to have occurred on the date the assets were transferred to such other corporation or corporations. For the purpose of this subsection one or more individuals shall be considered to be in control of a corporation if such individuals own directly or indirectly stock which represents at least 50 percent of the total combined voting power of the outstanding stock of such corporation of the total value of shares of all classes of stock of such corporation.

(b) *Transfer Not In Avoidance Of Tax.* — Subsection (a) shall not be applicable in any case in which it is established by the taxpayer that such transactions did not have as one of their principal purposes the avoidance of tax on corporate distributions of property under section 301.

(c) *Attribution Of Ownership.* — For the purpose of this section in determining the ownership of stock and the receipt of assets, section 311 shall be applicable.

169. Subsection (a).

170. Subsection (a) (1).

171. Subsection (b).

172. For a discussion of the methods used to achieve a reincorporation, see pp.

justifiable to state that the drafters of the statute were satisfied that the other methods employed to reincorporate would be effectively controlled by the definition of a "D" reorganization under the 1954 Revenue Act, as they had been under the 1939 Act.¹⁷³

The statute, however, had redeeming features. First, it was drafted so that only those shareholders of the liquidated corporation who transferred the operating assets they received on liquidation to a second corporation would be denied capital gains treatment.¹⁷⁴ Those who did not participate in the reincorporation were still entitled to capital gains treatment on the liquidation pursuant to section 331. This obviously was more equitable than present treatment afforded shareholders when the courts find that a reincorporation constitutes a reorganization. In such a case, the distribution to all the transferor's shareholders, even those who did not retransfer their assets, would be taxed pursuant to section 356(a)(1) and (2)¹⁷⁵ which provides that "boot" distributions received in a reorganization shall be treated as a dividend the extent of the liquidated corporations earnings and profits, if a gain is realized on the exchange. Therefore, those shareholders who arguably received a valid liquidating distribution because they intended to terminate their investment in the corporation¹⁷⁶ would be taxed at ordinary income rates. The inequities of taxing every shareholder in the same manner are obvious.¹⁷⁷

A second noteworthy aspect of this statute is that provision which calls for the transfer to the second corporation to be made pursuant to section 351.¹⁷⁸ That section provides for non-recognition of gain or loss when taxpayers transfer property to a corporation "in exchange for its stock or securities"¹⁷⁹ if, immediately after the transfer such persons are in *control* of the transferee corporation. "Control" in section 351 is defined the same as in section 368(c) — "ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation." As noted before, this definition enabled taxpayers to avoid a reorganization by intentionally losing control of the transferee corporation. However, this same definition of control when used in proposed section 357 worked for the benefit of the Commissioner. If the taxpayer attempted to fall without the purview of proposed section 357 by losing control of the transferee corporation, the transfer to the second corporation will not fall within

173. For an analysis of the reincorporation problem under the pre-1954 Code, see pp. 426-31 *supra*.

174. Subsection (a)(2).

175. INT. REV. CODE OF 1954, § 356(a)(1)(2). See p. 458 *infra* for a discussion of this section.

176. For a discussion of what constitutes a complete liquidation pursuant to section 331 of the 1954 Code, see p. 460 *infra*.

177. See p. 458 *infra* for an in-depth discussion of the inequities of section 356.

178. INT. REV. CODE OF 1954, § 351.

179. INT. REV. CODE OF 1954, § 351.

the non-recognition provisions of section 351. The transfer to the corporation then will be subject to ordinary income treatment. The tax burden on transferring assets without section 351 will be significantly greater than if the distribution or liquidation of the transferor which is not retransferred to the second corporation is taxed as a dividend pursuant to proposed section 357.¹⁸⁰ Attempting avoidance of this section, therefore, by giving up control of the transferee could only work to the detriment of the taxpayer.

A third aspect of proposed section 357 which merits discussion is subsection (b). It provided that the operative language of subsection (a) shall not apply if the taxpayer can prove that the transaction did not have as one of its "principal purposes" the avoidance of tax on a distribution pursuant to section 301.¹⁸¹ This provision created a rebuttable presumption in favor of the Service that the transaction was entered into for the purpose of tax avoidance. On this point one might have argued that requiring tax avoidance to be a principal purpose was a misjudgment or oversight on the part of the drafters. Practically, however, since these transactions are so complex, it may safely be said that they would not be carried out unless tax avoidance was the principal purpose. Illustrative of this point is *Joseph C. Gallagher*.¹⁸² In *Gallagher* the taxpayers claimed the following valid business reasons for entering into a liquidation-reincorporation: (1) to eliminate certain stockholders who no longer had an active part in the business; (2) to permit Gallagher to acquire sufficient stock to gain control; (3) to provide other members of management with shareholder status in order to instill in them incentive.¹⁸³ However, to achieve these business purposes the taxpayers effectuated an incredibly complex transaction which had, as a by-product, the distribution of the liquidated corporation's earnings and profits at capital gains rates.¹⁸⁴ These business purposes, however, could have been achieved by alternative means. The undesirable shareholders could have been redeemed out under section 302¹⁸⁵ and those who were interested in becoming shareholders of the company could have either purchased

180. For example, assume that corporation *A* liquidates and distributes operating and liquid assets to a single shareholder. The basis of the operating assets in the shareholder's hands will be their fair market value pursuant to section 334(a). If the taxpayer retransfers these assets to corporation *B*, thereby intentionally coming without section 351 by losing control of the company, he runs the risk of incurring a significant tax liability if the operating assets appreciate in value between the liquidation of *A* and retransfer to *B*. That is, the *B* stock which the taxpayer receives in exchange for the operating assets will have a value in his hands equal to the fair market of the assets at the time of the exchange. The gain, then, taxable at ordinary income rates, will be the difference between the value of the stock received and his basis for those assets which he acquired upon the liquidation of *A*.

181. For an explanation of section 301, see note 1 *supra*.

182. 39 T.C. 144 (1962), *acquiesced in result only*, 1964-2 CUM. BULL. 5.

183. *Id.* at 153-54.

184. *Id.* at 145-55.

185. INT. REV. CODE OF 1954, § 302(a), states that if a corporation redeems its stock within the meaning of subdivision (b), the distribution will be treated in "part or full payment in exchange for the stock" — capital gains treatment. Subdivision (b) then sets forth four situations when a redemption will be treated as an exchange.

the stock or have the company issue it to them in the form of additional compensation. Because of this fact, it is difficult to say that tax avoidance was not a principal purpose for entering into the reincorporation transaction.

B. *The Subchapter C Advisory Group Proposal*

In 1957, the Subchapter C Advisory Group suggested amendments to the Code which were aimed at plugging the reincorporation loophole.¹⁸⁶ Their solution was to redefine a "D" type reorganization as follows:

[A] transfer, whether by statutory merger or consolidation or otherwise, of all or a part of the properties of one corporation to another corporation if—

(i) immediately after the transfer the corporation whose properties are transferred or one or more of its shareholders, or any combination thereof, is in control of the acquiring corporation.

(ii) if the transfer is not by statutory merger or consolidation, the corporation whose properties are transferred is completely liquidated as part of the plan pursuant to which the transfer is made (whether such complete liquidation precedes, accompanies, or follows the transfer).¹⁸⁷

In addition, they proposed that section 356 be revised so that when "boot" is received in a reorganization that amount which has the "effect of a distribution of a dividend," or has the "effect of a distribution in redemption under section 302(b)," or has the "effect of a distribution in partial liquidation under section 346" shall be treated accordingly.¹⁸⁸ Also, the provision requiring a gain to be realized before a tax will be imposed was deleted.¹⁸⁹

The Subchapter C Advisory Group's proposed definition of a "D" type reorganization would have resolved a number of problems which currently plague the Commissioner in his attempts to fit a reincorporation into a "D" reorganization under the present Code. The language of the opening paragraph, when read in combination with subsection (i), is basically the same as the 1954 Code definition¹⁹⁰ except with a few small but important differences. The requirement that the transfer of assets be by a corporation a party to the reorganization was stricken and there was no reference to section 354 which requires that "substantially all" the assets of the transferor be exchanged for stock or securities in the transferee. A noticeable carry-over from the 1954 Code was the language in subsection (i) referring to where control must exist

186. The discussion herein is based on that part of the proposal set forth in an article by MacLean, Jr., *Problems of Reincorporation and Related Proposals of the Subchapter C Advisory Group*, 13 TAX L. REV. 407 (1958).

187. *Id.* at 421.

188. *Id.* at 423.

189. *Id.*

190. See pp. 434-46 *supra* for a discussion of the "D" type reorganization under the present Code.

after the transfer.¹⁹¹ Also, the section 368(c) control requirement of the 1954 Code was incorporated into the proposal.

Subsection (ii) remedied the defect of the 1954 House proposal (section 357) by encompassing every device employed to achieve a reincorporation. Although its scheme would seemingly frustrate this method of tax avoidance, a number of problems are evident. First, as with the existing Code, a "D" reorganization could be avoided by the taxpayer if more than 20 percent of the stock of the transferee was distributed to outsiders.¹⁹² As previously noted, the Tax Court considers 80 percent control an absolute requirement to finding a "D" reorganization.¹⁹³ Secondly, the reorganization provisions as originally enacted by Congress were not intended for this purpose and by drafting the "D" requirements so broadly, absurd and even harsh results may follow. For example, a taxpayer who owns 10 percent of a corporation may receive on its liquidation his proportional share of operating and liquid assets. If he decides to establish a second corporation with the operating assets he received on liquidation he would come within the Subchapter C Advisory Group's "D" reorganization definition since what is required is that "part" of the assets of the liquidated corporation be transferred. Also, a shareholder of the liquidated corporation will own 100 percent of the second corporation, thereby clearly meeting the control requirement of section 368(c). Upon finding a "D" reorganization the distribution of the liquid assets may be found to have the effect of a dividend if the requirements of proposed section 356 are met.

Imposing "D" reorganization treatment in this context, however, is difficult to reconcile with the traditional concept of a reorganization.¹⁹⁴ Congress extends tax benefits to corporations that reorganize because it considers that what in essence existed after the reorganization transaction was essentially the same business under the same control as before. That is, since there is a "continuity of interest"¹⁹⁵ between the old and new corporations, Congress did not feel that this event was a proper incident upon which to impose a tax. However, when something less than 10 percent of the operating assets of a liquidated corporation are employed in a second corporation it is difficult to say that the second corporation is the alter ego of the first. Though the Code's present requirement of transferring "substantially all" the assets is a difficult standard to apply,¹⁹⁶ it at least assures a continuity between the liquidated and second corporation and justifies affording non-recognition treatment to the transaction.

The Subchapter C Advisory Group's proposal regarding section 356, however, would have been an extremely logical approach to taxing liqui-

191. See p. 456 *supra* for the text of subsection (i) and compare with INT. REV. CODE of 1954, § 368(c).

192. MacLean, Jr., *supra* note 186, at 429-30.

193. See p. 442 *supra*.

194. See p. 430 *supra*.

195. See pp. 442-43 *supra*.

196. See pp. 436-40 *supra*.

dating distributions followed by a reincorporation. Section 356 presently provides that when "boot" is received in a reorganization and such distribution has the effect of a dividend it shall be recognized as such to the extent of any gain realized on the transaction. The Advisory Group's proposal, however, would analyze each shareholder's position with respect to the liquidated corporation in order to determine the treatment his distribution should receive. In addition, there would be no requirement that a gain must be realized before a recognizable event occurs. To illustrate the difference in these two approaches to the taxation of "boot" distributions, an analysis of the facts of *Joseph C. Gallagher*¹⁹⁷ under both is in order.

There were basically three types of shareholders in the *Gallagher* case: first, those who had a substantial interest both in the liquidated company and in the reincorporated business; second, those who had a substantial interest in the liquidated company but whose interest in the reincorporated business was significantly reduced; third, those who had an interest in the liquidated company and no interest in the reincorporated company. Under the present Code, if the Commissioner had found that a "D" reorganization occurred the "boot" distributions of the liquidated company to all three types of shareholders would receive similar treatment under present section 356. However, under the Advisory Group's proposal each type of shareholder would be considered separately. The first type would receive dividend treatment since their interest in the same business had not changed, even though the business exists in a different corporate form whether or not they realized a gain. The second group of shareholders, however, may be entitled to capital gains treatment pursuant to section 302(b)(2)(C). If it can be established that the liquidating distribution has the effect of a "substantially disproportionate" redemption to them, capital gains and not dividend treatment will result.¹⁹⁸ The third group, since their investment in the business is completely eliminated, should under no circumstances receive dividend treatment. The proposal, therefore, would treat the distribution to them as one in complete liquidation of the company pursuant to section 331 — capital gains.

C. Sham Liquidation

A third method of attacking these transactions under the existing Code, in addition to the reorganization route, is to employ the form versus substance dichotomy. Although urged by numerous commentators¹⁹⁹ and argued by the Commissioner in cases involving liquidation-reincorporation,²⁰⁰ the Tax Court has literally ignored this approach.

197. 39 T.C. 144 (1962), *acquiesced in result only*, 1964-2 CUM. BULL. 5.

198. See note 186 *supra*.

199. Lane, *The Reincorporation Game: Have The Ground Rules Really Changed?*, 77 HARV. L. REV. 1218, 1226 (1964); Rice, *When is a Liquidation Not a Liquidation For Federal Income Tax Purposes?*, 8 STAN. L. REV. 208, 227 (1956); Schwartz, *Reincorporations Under The 1954 Code*, 15 U. FLA. L. REV. 159, 165 (1962).

200. E.g., *Pridemark, Inc. v. Commissioner*, 345 F.2d 35, 41 (4th Cir. 1965), *rev'd*

The crux of the argument is that a liquidation, followed by a reincorporation, regardless of how effected, should be ignored as a sham transaction with the distribution of the disappearing company being treated as a dividend under section 301 rather than as a capital gain under section 331. This argument derives its basis from *Gregory v. Helvering*,²⁰¹ which held that if a transaction is entered into for no other purpose than tax avoidance, it shall be ignored for tax purposes and the substance of the transaction shall control the tax consequences. When corporation A liquidates and shortly thereafter reappears in the form of corporation B, the proponents of this argument urge that in fact A was never liquidated since it still exists in another form, and the shareholders of that corporation should not receive the benefits of a capital gain. However, it is not clear that *Gregory* could be pushed to the point of ignoring the fact that one recognizable taxable entity has disappeared and that another has arisen.²⁰² This is seemingly the stumbling block which has not, as of now, been successfully bridged by the Service. The Service may, however, find some support for treating the transactions as involving only one corporation in the decision of the Tax Court in the *Casco Prods. Corp.*²⁰³ case. In *Casco*, the majority shareholder (Standard Kollsman), merged Old Casco into New Casco. However, in the succeeding year New Casco sustained a loss and the question was whether it could be carried back to Old Casco's earnings for the purpose of securing a tax refund. The Tax Court allowed the carryback but not on the basis that the transaction constituted an "F" type reorganization. The Tax Court felt that "the merger itself, *although in form a reorganization*, had as its sole purpose the accomplishment of a redemption"²⁰⁴ and held "that New Casco was simply a continuation of Old Casco and the loss carryback should have been allowed."²⁰⁵ The court obviously ignored the existence of two separate and distinct taxable entities in favor of characterizing the transaction on the basis of its substance rather than the procedure used by the taxpayer. Although a valid business purpose existed for the procedure used in *Casco* as distinguished from the liquidation-reincorporation procedure,²⁰⁶ the basic thrust of the case placing substance over form and ignoring the fact that two distinct taxable entities were parties to the transaction is just as applicable to the liquidation-

201. 293 U.S. 465 (1934).

202. For a discussion of this point, see Comment, *Liquidation — Reincorporation — Commissioner Confined to Reorganization Approach in First Cases Under the 1954 Code*, 32 U. CIN. L. REV. 416, 428 (1963).

203. 49 T.C. 32 (1967). See also Rev. Rul. 66-284, 1966-2 CUM. BULL. 115.

204. 49 T.C. at 36 (emphasis added).

205. *Id.* at 37.

206. See Rev. Rul. 61-156, 1961-2 CUM. BULL. 62, where tax avoidance was pointed to as a critical factor in its ruling to segregate off and restructure certain transactions. See pp. 443-46 *supra*. It does not seem that one would be stretching *Casco* to any great extent by using the same form versus substance test to ignore the liquidation-reincorporation to find that one corporation exists and that any distributions made during the series of transactions in question amounted to a distribution with respect to one's stock within the purview of section 301. The only distinguishing factor between the *Casco* case and the situation in the revenue ruling is that in the latter

reincorporation transaction. That is, in the liquidation-reincorporation situation the substance of the transaction may be either a redemption, a distribution with respect to stock, or a new issuance, or all of these or any two of these.

The Tax Court's reluctance to use this argument as a vehicle to avoid reincorporation is rather surprising in view of analogous cases which have ignored the formalities of a transaction even though motivated by a business purpose. In *United States v. General Geophysical Co.*,²⁰⁷ the taxpayer distributed assets with a book value of \$169,290 to two shareholders in complete redemption of their stock. A few hours after this transaction the corporation repurchased the assets at their market value of \$764,525 from the same shareholders. The litigation arose because the corporation attempted to depreciate these assets at a basis equal to the amount it repurchased them from the shareholders. The court struck down the depreciation deduction, holding that there was not a sufficient interruption in the ownership of the assets to permit the establishment of a new basis for depreciation purposes.²⁰⁸ Additionally, the court noted that each case of this type "must be decided on its own merits by examining the form and substance of the transactions and the purpose of the relevant tax provisions to determine whether recognition of the form of the transaction would defeat the statutory purpose."²⁰⁹

The Code itself, however, acts somewhat as a barrier to the acceptance of this argument in the reincorporation area. Section 331(b) states that "section 301 . . . shall not apply to any distribution of property . . . in partial or complete liquidation." If a transaction, then, comes within the literal language of section 331(a), subsection (b) would presumably prevent the distribution from receiving dividend treatment pursuant to section 301. But, if it could be shown that a "complete liquidation" is foreign to the concept of a reincorporation, subsection (b) would seemingly be inapplicable and the sham liquidation argument would have more appeal. However, the Code again is the drawback since no where does it define the term "complete liquidation."

A concept of what a "complete liquidation" is, however, can be gleaned from the regulations and case law. Treas. Reg. § 1.332-2(c) states that a "status of liquidation exists when the corporation ceases to be a going concern and its activities are merely for the purpose of winding up its affairs, paying its debts, and distributing any remaining balance to

case the form versus substance test will increase rather than mitigate the tax burden. See also Hyman H. Berghash, 43 T.C. 743 (1965), where the court stated:

[W]here it is apparent that the corporate entity utilized by the parties to a given transaction is a sham corporation or that the transaction in question otherwise was without economic substance, we are not reluctant to disregard the formalities employed and reach a result dictated by the substance thereof.

Id. at 749 (emphasis added).

207. 296 F.2d 86 (5th Cir. 1961), cert. denied, 369 U.S. 849 (1962).

208. *Id.* at 89-90.

209. *Id.* at 88.

its shareholders." In the case of *Kennemer v. Commissioner*,²¹⁰ decided under the pre-1954 Code, the court held that the "determining element [for deciding whether a complete liquidation occurred] was the intention to liquidate . . . coupled with the actual distribution of the cash to the stockholders."²¹¹ In *Pridemark*, the court stated that for a complete liquidation to occur "[t]he corporation must have ceased to be a going corporate concern, or if the enterprise is continued in corporate form, the shareholder must have disassociated himself from it."²¹²

A concept unifying these statements is that the term "complete liquidation" in section 331 involves some sort of termination of the business as a going concern. Though there is some authority for the proposition that the business does not have to dissolve to come within section 331,²¹³ in that its existence can continue as a corporate shell, the active nature of the business must cease. Comparing this view of complete liquidation with the reasons for effectuating a reincorporation, an earnings bail-out coupled with a continuation of the business in a modified corporate form, the logical conclusion is the inapplicability of section 331 to a reincorporation. Although formally speaking corporate life was drained from one entity, substantively the same business with the same ownership exists in another form.

Employment of a "sham liquidation" argument would also have a desirable side effect on the taxpayers involved in these transactions. By not finding a reorganization, the Commissioner would not be tied to the tax consequences of section 356 and could impose a tax on the liquidating distribution similar to that suggested in the Subchapter C Advisory Group's report.²¹⁴ Also, upon finding that the liquidation was a sham the corporate attributes of the disappearing corporation would necessarily carry-over to the continuing business, since the foundation of this argument is that the business never ceased but merely continued in a different corporate form. Although, as noted, there are some problems with analyzing a reincorporation in this manner, it seemingly is a more logical and equitable approach to this problem which does not have the concomitant result of creating confusion.

V. PROPOSAL

Before a solution to the reincorporation problem may be posited the end result to be achieved must first be set forth. As pointed out in part IV of this Comment, the primary advantage of the prior proposals was their equitable manner of imposing a tax on a shareholder by shareholder basis rather than the tax imposed by section 356 when a reorganization is found. Therefore, regardless of the manner in which a reincorporation is achieved, three alternative possibilities for taxing the distribu-

210. 96 F.2d 177 (5th Cir. 1938).

211. *Id.* at 178.

212. 345 F.2d 35, 41 (4th Cir. 1945).

213. Rev. Rul. 54-518, 1954-2 CUM. BULL. 142.

214. See pp. 452-453.

tion should be available. First, the distribution with respect to this transaction may be a dividend pursuant to section 301 or, second, a valid liquidation pursuant to section 331 or, thirdly, a redemption pursuant to section 302 or section 346. Since the existing Code would not treat a distribution in this manner a new Code section, designed specifically for the reincorporation area, is necessary.

Initially, a specific statute must avoid the pitfalls of the 1954 House proposal as was done in the proposal of the Subchapter C Advisory Group. That is, all possible methods available to effectuate this transaction must be brought within the ambit of the statutory language. However, this does not mean that all reincorporations should be treated in this special manner. For example, if corporation A liquidates and 5 percent of its shareholders reincorporate in corporation B, should the tax consequences of the statute come into play? It is suggested that such a transaction should not come within the statute, but rather a continuity of business and a continuity of shareholder interest test should be employed to determine when a liquidation-reincorporation should receive this special treatment. In addition, the statute should specifically incorporate the constructive attribution rules of section 318 in order to avoid a possible loophole with regard to the continuity of shareholder interest. Furthermore, section 381 providing for the carryover of corporate attributes and section 362 providing for the carryover of basis should be specifically incorporated by reference. Once the transaction is characterized on the corporate level, then the distribution to the shareholders must be analyzed and taxed pursuant to either sections 301, 331, or 302 and 346.

Treating a transaction in this manner is not foreign to the Internal Revenue Code. Section 304 is analogous in that it provides that if two corporations are controlled by one person or persons and if one corporation purchases the stock of the corporation from those in control, the transaction will be treated as a redemption of the stock of the acquiring corporation from the control group. By defining a purchase of stock by brother-sister corporations from a control person as a redemption, section 304 brings into operation section 302. If such a redemption does not meet the requirements of 302(b) the transaction will not be treated as an exchange (capital gains) but rather will receive ordinary income treatment pursuant to section 301. Section 304 then prevents two or more brother-sister corporations from bailing-out earnings at capital gains rates. The above format to resolve the liquidation-reincorporation problem is similar to section 304 both in its purpose and in its imposition of taxes on a shareholder by shareholder basis. The one difference is that any statute designed to resolve the liquidation-reincorporation problem must also provide for the carryover of corporate attributes and basis.

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